

Audit



Report

OFFICE OF THE INSPECTOR GENERAL

INVENTORY ACCOUNTS ON THE FINANCIAL
STATEMENTS OF THE DEFENSE LOGISTICS AGENCY
BUSINESS AREAS OF THE DEFENSE BUSINESS
OPERATIONS FUND FOR FY 1993

Report No. 94-150

June 28, 1994

Department of Defense

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Acronyms

DLA
DRMS
IG

Defense Logistics Agency
Defense Reutilization and Marketing Service
Inspector General



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202

June 28, 1994

MEMORANDUM FOR SECRETARY OF DEFENSE
COMPTROLLER OF THE DEPARTMENT OF DEFENSE
DIRECTOR, DEFENSE LOGISTICS AGENCY
DIRECTOR, DEFENSE FINANCE AND
ACCOUNTING SERVICE

SUBJECT: Audit Report on Inventory Accounts on the Financial Statements of the
Defense Logistics Agency Business Areas of the Defense Business
Operations Fund for FY 1993 (Report No. 94-150)

We are providing this report for your review and comments. Financial statement audits are required by the Chief Financial Officers Act of 1990. Comments on a draft of this report were considered in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Defense Finance and Accounting Service must provide final comments on the recommendations by August 29, 1994. Additional comments to the final report are also requested from the Comptroller of the Department of Defense and the Defense Logistics Agency, by that date.

The courtesies extended to the audit staff are appreciated. If you have any questions on this audit, please contact Mr. Charles F. Hoeger, Audit Program Director, or Mr. Bernard J. Siegel, Audit Project Manager, at (215) 737-3881 (DSN 444-3881). The distribution of this report is in Appendix G. The audit team members are listed on the inside back cover.

A handwritten signature in black ink, reading "Robert J. Lieberman", is positioned above the typed name.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 94-150
(Project No. 3LD-2022)

June 28, 1994

INVENTORY ACCOUNTS ON THE FINANCIAL STATEMENTS OF THE DEFENSE LOGISTICS AGENCY BUSINESS AREAS OF THE DEFENSE BUSINESS OPERATIONS FUND FOR FY 1993

EXECUTIVE SUMMARY

Introduction. The Chief Financial Officers Act of 1990 requires DoD to prepare financial statements for revolving funds. The Defense Logistics Agency Defense Business Operations Fund (the Fund) is a revolving fund established for procuring, storing and selling consumable supply items to DoD Components and other Government agencies; controlling and maintaining industrial plant and equipment for DoD Components and other users; disposing of excess and surplus materiel; and manufacturing selected clothing items. The Fund reported \$16.3 billion of inventory held for sale and \$125.8 million of inventory not held for sale on the FY 1993 financial statements.

This audit is one of a series of audits being conducted by the Inspector General, DoD, in response to the Chief Financial Officers Act of 1990, which requires an annual audit of the financial statements of the Fund. This audit of inventory accounts was conducted in conjunction with audits of the Fund's management data (Report No. 94-128); plant, property, and equipment account (Report No. 94-149); and fund balance with the Treasury account (Report No. 94-159) for the Fund's FY 1993 financial statements. The audits are part of a building block approach to provide audit coverage of the Fund's progress in improving financial reporting and internal controls to the point where formal audit opinions can be rendered on the Fund's financial statements.

Objectives. The objectives of the audit were to:

- o Determine whether the inventory accounts on the FY 1993 financial statement of the Fund are presented fairly in accordance with generally accepted accounting principles,
- o Evaluate the internal control structure for inventories, including inventories held for sale and inventories not held for sale, and
- o Assess compliance with applicable laws and regulations for those transactions and events that have a direct and material effect on the inventory accounts.

Audit Results. General ledger accounts, non-financial records, and yearend accounting adjustments did not reflect the correct value of inventory under the control and management of the Defense Logistics Agency. As a result, the asset balances presented on the financial statements were misstated; were not properly categorized; did not include all reportable inventories; and did not disclose all restrictions on the sale, use, or disposition of inventories and other non-financial resources. Inventory held for sale was materially misstated because stock on hand for the reutilization and

marketing business area was overstated by about \$5 billion and, based on our projection, stock on hand for the supply management business area was understated by about \$442 million.

Internal Controls. The audit identified material internal control weaknesses. Controls were not adequate to ensure that the results of physical inventory counts were accurate and posted to the accountable records, and that general ledger account balances were reconciled with related subsidiary records to periodically verify the accuracy of subsidiary records with related supporting documents. Additionally, data presented on the financial statements of the Fund were not presented in accordance with applicable Office of Management and Budget and DoD guidance. The internal controls reviewed are discussed in Part I and the weaknesses found are discussed in Part II.

Potential Audit Benefits. Monetary benefits were not quantifiable. Nonmonetary benefits include improved controls over inventory transactions, compliance with applicable laws and regulations, and more accurate and useful presentations of financial results.

Summary of Recommendations. We recommended that procedures and controls be established to ensure that general ledger accounts, non-financial records, and year-end accounting adjustments reflect the correct value of inventory under the control and management of the Defense Logistics Agency. We recommended that physical inventory procedures and related reconciliations be properly performed; that subsidiary records and documentation provide adequate support for inventory accounts, other than stock on hand; and that valuations, categorization, and disclosures on the financial statements be performed in accordance with Office of Management and Budget and DoD guidelines. Additionally, we recommended that a method be developed to value reutilization and disposal inventory held by wholesale supply activities that accurately reflects the best estimate of net realizable value.

Management Comments. The Defense Logistics Agency concurred with the recommendations concerning inventory counts and support for inventory accounts, other than stock on hand. Additionally, the Defense Logistics Agency concurred with the valuation, categorization, and disclosure issues identified in the report but nonconcurred that they were material internal control weaknesses. The Defense Logistics Agency will not revise the FY 1993 financial statements and related notes to the financial statement, including comparative FY 1992 financial data and disclosures, because of administrative and time constraints.

The Comptroller of the DoD concurred with the recommendations concerning inventory counts and support for inventory accounts, other than stock on hand. The Comptroller nonconcurred with the recommendations concerning valuation and disclosure of Defense Logistics Agency inventory accounts. Comments were not received from the Defense Finance and Accounting Service.

Audit Response. The comments from the Defense Logistics Agency were responsive; however, the FY 1993 financial statements will not be revised. Recommendations regarding the valuation, categorization, and disclosure of inventory will be made to the FY 1994 financial statements. Based on the Comptroller's comments we revised the report to clarify the discussion of property categorized as non-financial resources and the associated recommendations.

We request that the Defense Logistics Agency and the Comptroller of the DoD provide additional comments on the unresolved issues, and that the Defense Finance and Accounting Service provide comments to the final report by August 29, 1994.

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This report was prepared by the Logistics Support Directorate, Office of the Assistant Inspector General for Auditing, Department of Defense.

Part I - Introduction

Background

The Chief Financial Officers Act of 1990 (Public Law 101-576) requires the DoD to prepare financial statements covering substantial commercial functions, revolving funds, and trust funds of the department. Financial statements are expected to provide information to DoD program managers, the Congress, and the public, facilitating both effective allocation of resources and assessment of management performance and stewardship.

The Defense Logistics Agency (DLA) Defense Business Operations Fund (the Fund), is a revolving fund established under the administration and management of the Director, DLA, and consists of five business areas -- supply management, distribution depots, industrial plant equipment, reutilization and marketing, and clothing factory. The business areas are established for the purpose of procuring, storing, and selling consumable supply items to DoD Components and other Government agencies; controlling and maintaining industrial plant equipment for DoD Components and other users; disposing of excess and surplus materiel; and manufacturing selected clothing items.

Most sales proceeds from supply management are retained in the fund and are available for the procurement of replenishment stock for inventory and for the reimbursement of support services provided by other business areas. Sales proceeds from other business areas are reimbursements received from other Fund business areas and other DoD Components and are used to pay for the operations and maintenance costs of the business areas. The Defense Finance and Accounting Service maintains the official accounting records. Preparation of the FY 1993 financial statements was a joint responsibility of DLA and the Defense Finance and Accounting Service.

The Office of the Comptroller of the DoD issued "DoD Guidance on Form and Content of Financial Statements for FY 1993 and FY 1994 Financial Activity," January 12, 1994, providing guidance for the preparation and presentation on the FY 1993 financial statements, as required by the Chief Financial Officers Act. An audit report for the Fund's FY 1993 financial statements is required to be submitted to the DoD Chief Financial Officer by June 30, 1994. The audit report is required to contain an opinion on whether the financial statements are presented in all material aspects in accordance with applicable accounting standards and an evaluation of internal controls and compliance with applicable laws and regulations. On March 8, 1994, we received the Fund's FY 1993 financial statements, dated February 2, 1994.

Objectives

The objectives of the audit were to:

- o Determine whether the inventory accounts on the FY 1993 financial statement of the Fund are presented fairly in accordance with generally accepted accounting principles,
- o Evaluate the internal control structure for inventories, including inventories held for sale and inventories not held for sale, and
- o Assess compliance with applicable laws and regulations for those transactions and events that have a direct and material effect on the inventory accounts.

Scope and Methodology

This audit is one of a series of audits being conducted by the Inspector General (IG), DoD, in response to the Chief Financial Officers Act of 1990. This audit of inventory accounts was conducted in conjunction with audits of the Fund's management data (Report No. 94-128); plant, property, and equipment account (Report No. 94-149); and fund balance with the Treasury account (Report No. 94-159) for the Fund's FY 1993 financial statements. The audits are part of a building block approach to provide audit coverage of the Fund's progress in improving financial reporting and internal controls to the point where formal audit opinions can be rendered on the Fund's financial statements.

The audit evaluated the reasonableness of the inventory general ledger accounts for materiel managed by the Fund and adjustments made to account balances for presentation on the financial statements. We limited our assessment to selected inventory accounts and reviewed procurement and supply records, receipt and issue data, inventory adjustments and reports, and financial transactions and summaries occurring principally during FY 1993. Additionally, we included a review of other non-financial resources to determine whether any inventory-type materiel was included in the value reported on the financial statements. The definitions of inventory held for sale, inventory not held for sale, and other non-financial resources, and the value for each that was presented in the financial statements for FY 1993, are contained in Appendix A.

We did not review the inventory balance for the fuel commodity, which represents \$1.9 billion (11.5 percent) of the total reported inventory. The fuel commodity was reviewed during our audit of the DLA financial statements for FY 1992 and IG, DoD, Report No. 93-164, "Financial Statements of the Defense Logistics Agency Supply Management Division of the Defense Business Operations Fund (Defense Fuel Supply Center Financial Data) for

Introduction

FY 1992," September 2, 1993, identified no significant misstatements regarding the existence, valuation, categorization, or disclosure of fuel inventory. No work was performed at the Defense Clothing Factory because the factory is scheduled for closure at the end of FY 1994 and the value of inventory represents only \$7.7 million (0.05 percent) of the total reported inventory. Additionally, no work was performed at the National Security Agency because the value of inventory represents only \$16.4 million (0.1 percent) of the total reported inventory.

Universe. DLA uses general ledger accounts, valued at the latest acquisition cost, to maintain the financial balances for seven categories of inventory. As shown in Table 1., DLA general ledger inventories for the clothing factory and supply management business areas were \$12.557 billion, as of September 30, 1993. No inventories were reported in the general ledger accounts for the distribution depots, industrial plant equipment, and reutilization and marketing business areas.

**Table 1. Inventory Value in the General Ledger Accounts
as of September 30, 1993
(billion)**

<u>GLAC¹</u>	<u>Account Title</u>	<u>Value</u>
130	Stock on Hand	\$12.182
131	With Contractors/Test Agencies	0.075
132	In Process of Assembly/Disassembly	0.050
135	Temporarily in Use	0.001
140	Intransit From Procurement	0.105
141	Intransit Between Storage Locations	0.141
142	Intransit from Customers	0.003
Total		<u>\$12.557²</u>

¹General Ledger Account Code.

²Represents \$12.549 billion of inventory identified in the supply management business area general ledger accounts and \$7.7 million of inventory (in process of assembly/disassembly) in the operations and maintenance general ledger inventory account of the Defense Clothing Factory.

General ledger account balances are the initial source of financial data used in developing the FY 1993 financial statements. Inventory balances that are maintained in non-financial records are added to the general ledger account balances and revalued to reflect either the latest acquisition cost for serviceable and nonexcess inventory, or net realizable or market value for excess and unserviceable inventory. Financial resources, including inventory held for sale, and non-financial resources, including inventory not held for sale and other non-financial resources, are defined in the "DoD Guidance on Form and Content of Financial Statements for FY 1993 and FY 1994 Financial Activity." The definitions for those categories of assets are contained in Appendix A. For understandability of the financial statements and uniformity in presentation, notes to the financial statements have been identified by number for specific information.

According to the FY 1993 financial statements, inventories had an adjusted value of \$16.469 billion -- \$16.343 billion inventory held for sale and \$126 million inventory not held for sale -- that accounted for 80 percent of the Fund's total assets (\$20.549 billion). Table 2. shows the reported value of inventory held for sale and inventory not held for sale for each of the Fund's business areas.

Table 2. Inventory Value Reported on the Financial Statements for FY 1993
(billion)

<u>Business Area</u>	<u>Held For Sale</u>	<u>Not Held For Sale</u>	<u>Value</u>
Supply Management	\$11.198	\$0.118	\$11.316
Distribution Depots	0.000	0.000	0.000
Industrial Plant Equipment	0.000	0.000	0.000
Reutilization and Marketing	5.145	0.000	5.145
Clothing Factory	0.000	0.008	0.008
Total	<u>\$16.343</u>	<u>\$0.126</u>	<u>\$16.469</u>

Samples. For inventory stock on hand (general ledger account code 130), we selected a multistage stratified random sample of items to determine whether the quantity on hand was substantially different from the quantity on the accountable records, and whether the year end valuation method was representative of the latest acquisition cost or other appropriate cost method. Our tests were limited to supply management inventories (excluding fuel) stored in the continental United States. The sample was selected by the DLA Operations and Research Office in coordination with personnel from our Quantitative Methods Division.

For inventory accounts other than stock on hand, we judgmentally selected samples of transactions that were over 180 or 360 days old, and transactions with large dollar values to determine whether the transactions were valid and properly valued as of September 30, 1993. Data relating to the sampling techniques used to evaluate the reasonableness of the inventory accounts are contained in Appendix B.

Audit Period, Standards, and Location. This financial statement audit was performed from September 1993 through March 1994, in accordance with the Office of Management and Budget Bulletin No. 93-02, "Form and Content of Agency Financial Statements," October 22, 1992; Comptroller of the DoD, "DoD Guidance on Form and Content of Financial Statements for FY 1993 and FY 1994 Financial Activity"; and generally accepted auditing standards issued by the Comptroller General of the United States as implemented by the IG, DoD. The audit included such tests of the internal controls as were considered necessary. We analyzed the inventory data available from computer reports, records, and statistics that were used by DLA to manage financial inventories. Except for our tests of physical inventory observations and selected tests of other than stock on hand inventory accounts, we did not independently determine the reliability of the computer-processed data. Organizations visited or contacted during the audit are listed in Appendix F.

Internal Controls

Controls Assessed. We evaluated internal controls applicable to regulations and procedures that DLA business areas used to manage and control Fund inventories; and we considered the internal control structure related to inventory accounts.

Internal Control Structure. We classified internal control structure policies and procedures into:

- o general ledger, which consists of policies and procedures associated with reconciling general ledger account balances with subsidiary ledgers and supporting records;

- o inventories, which consists of policies and procedures associated with receiving, storing, inventorying, issuing, and valuing inventories;

- o financial reporting, which consists of the policies and procedures used to prepare financial statements; and

- o transaction processing, which includes the processing and flow of financial data into the financial accounts.

DoD Internal Management Control Program. We also evaluated the process by which DLA and the Defense Finance and Accounting Service implemented the DoD Internal Management Control Program as it relates to financial inventory accounts. In the DoD Annual Statement of Assurance for FY 1993, the Secretary of Defense concluded:

Except for the control weaknesses and financial management deficiencies noted in the [Annual Statement of Assurance] report, the methods and procedures in place are sufficient to safeguard the Department's resources. Controls, where deficient, are offset by other effective controls and reliable procedures that assure the Department's ability to field forces and provide an appropriate response to actions directed by the President.

The following is a list of reported financial management deficiencies relating to physical controls over inventory.

- o The quality of financial information was questionable.
- o Financial management practices were inadequate.
- o Property records and physical control of property were inadequate.
- o The maintenance of financial records for inventory and property was inadequate.

Internal Control Weaknesses. The audit disclosed material internal control weaknesses as defined by DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987. DLA performed a risk assessment on inventory management, which included the accuracy of recording the results of physical inventories, and concluded that the risk for this assessable unit was low to medium. The Defense Finance and Accounting Service performed a risk assessment for the analysis and reconciliation of general ledger accounts and concluded that the risk for this assessable unit was low to medium. However, the DoD Internal Management Control Program was not effectively implemented by DLA and the Defense Finance and Accounting Service because the assessable unit only included a review of significant errors or irregularities. As a result, DLA assessments did not disclose that established controls were not adequate to ensure that the results of physical inventory counts were accurate and posted to the accountable records, and that general ledger account balances were reconciled with related subsidiary records to periodically verify the accuracy of subsidiary records with related supporting documents. Additionally, data presented on the financial statements of the Fund were not presented in accordance with applicable Office of Management and Budget and DoD guidance.

The recommendations in this report, if implemented, will correct the internal control weaknesses. No quantifiable monetary benefits were associated with those recommendations. A copy of the final report will be provided to the senior officials responsible for internal controls within the Office of the Secretary of Defense, DLA, and the Defense Finance and Accounting Service.

Prior Audits and Other Reviews

During the last 3 years, three audit reports relating to Chief Financial Officers reviews were conducted on various elements of the Fund. Each report evaluated the management controls used to ensure that selected account values presented on the financial statements were free of material errors and fully supported by subsidiary records and required documentation.

The audit reports generally showed that management did not perform reconciliations to ensure that general ledger accounts were accurate and supported by subsidiary records. Our audit determined that the reconciliations were still not being performed. The principal audits are summarized in Appendix C.

Part II - Finding and Recommendations

Presentation of Financial Data for Inventory Accounts and Other Non-Financial Resources

General ledger accounts, non-financial records, and year-end accounting adjustments did not reflect the correct value of inventory and other non-financial resources under the control and management of the Defense Logistics Agency. The condition occurred because:

- o Physical inventory procedures and related reconciliations were not properly performed.
- o Subsidiary records and documentation did not provide adequate support for inventory accounts, other than stock on hand.
- o Valuations, categorization, and disclosures on the financial statements were not done in accordance with Office of Management and Budget and DoD guidelines.

As a result, the inventory balances presented on the financial statements were misstated; were not properly categorized; did not include all reportable inventories; and did not disclose all restrictions on the sale, use, or disposition of inventories and other non-financial resources. Inventory held for sale was materially misstated because stock on hand for the reutilization and marketing business area was overstated by about \$5 billion and, based on our projection, stock on hand for the supply management business area was understated by about \$442 million.

Background

DLA uses a perpetual inventory system and manages inventory in the supply management business area on an item-by-item basis, each item having a unique national stock number. The inventory system maintains a continuous record of inventory, increasing the balance when stock is received and decreasing the balance when stock is issued. DoD Manual 7220.9-M, "DoD Accounting Manual," October 1983, provides that any item purchased by a DoD Component shall be brought under financial accounting control and recorded in the applicable inventory general ledger until issued.

The supply management business area of the Fund uses seven general ledger accounts to maintain financial control over inventory. One account is for stock on hand and six accounts are for other than stock on hand. Inventory in the accounts can be categorized, for financial statement purposes, as either inventory held for sale or inventory not held for sale. Supply management

Presentation of Financial Data for Inventory Accounts and Other Non-Financial Resources

stock on hand totaled \$12.2 billion and other supply management inventory accounts totaled \$366 million. Inventory work in process at the clothing factory was reported at \$7.7 million. All inventory accounts were valued at either the latest acquisition cost or the cost to manufacture.

No general ledger account balances were maintained for inventory for the distribution depots and the industrial plant equipment business areas. Reutilization and marketing inventories were reported as \$5.1 billion, valued at original acquisition cost, on the financial statements; however, non-financial records showed \$7.8 billion as the standard price of the materiel at the time the materiel was turned in to the Defense Reutilization and Marketing Service (DRMS).

Accuracies of Inventory Accounts

We reviewed the general ledger accounts, non-financial records, and year-end accounting adjustments and found that the inventory value shown in the financial statements did not reflect the correct value of inventory under the control and management of DLA. All seven general ledger accounts used to maintain financial control over the inventory were not accurate and in total the inaccuracies had a material effect on the reliability of the financial statements. The inaccuracies occurred because physical inventory procedures and related reconciliations were not properly performed; subsidiary records and documentation did not provide adequate support for inventory accounts, other than stock on hand; and valuations, categorization, and disclosures on the financial statements were not done correctly and in accordance with Office of Management and Budget and DoD guidelines.

Physical Inventory Procedures and Related Reconciliations

Physical inventory count quantities were not always reported to wholesale supply activities; were reported with different quantities than the observed counts and reconciliations; and results were reported, rejected from the supply system, and not corrected and posted to the accountable records. We projected, for physical inventory adjustments, that the inventory stock on hand for the supply management general ledger was understated by about \$442 million, at the latest acquisition cost. We are 90-percent confident that the net understatement of inventory for the 21 storage depots is from \$84 million to \$801 million. Based on our analyses and statistical projections of inventory tests for those commodities, the inventory general ledger account balance for supply management stock on hand was materially misstated.

Presentation of Financial Data for Inventory Accounts and Other Non-Financial Resources

This misstatement represented a material misstatement of inventory held for sale of 1 to 7 percent of the reported inventory value. We considered 1 percent to be material. The magnitude of the misstatement of inventory was attributed to inventory gains resulting from previously recorded disposal transactions that were not accomplished; prior inventory loss adjustments because customer requisitions were denied, but the materiel was on hand; the inadequate reconciliation of prior physical inventory counts; and other administrative errors. Additionally, we identified material misstatements in other business areas. Our statistical sampling plan and projection are described in Appendix B.

The DoD Accounting Manual provides that physical inventory counts be taken periodically to provide reasonable assurance that stock records accurately reflect on hand quantities and that the amounts shown in the inventory general ledger accounts are reasonable. The inventory counts are an important control to verify the accuracy of the perpetual inventory system. Storage depot personnel conduct scheduled inventory counts, depending on resources available, as well as unscheduled inventory counts relating to special requests or materiel release denials. Storage depots reported the results of the inventory counts to supply managers who adjusted the stock and accounting records for gains or losses.

Inventory Stock on Hand. Inventory stock on hand (general ledger account code 130) represented the financial value of Fund inventories that are carried in the on-hand balance of the national inventory record file maintained by supply centers and the on-hand balance of base operating supplies maintained at supply centers and distribution depots. Inventories of the reutilization and marketing business area are also inventory stock on hand, but the inventories are not maintained in a general ledger account. To determine whether the value of the inventory stock on hand was reasonably shown on the financial statements, we reviewed the physical inventory and the associated reconciliation process and reviewed the method used to categorize and value the inventory for financial statement purposes. Inventory stock on hand consists of different categories of inventory that are reported as either inventory held for sale or inventory not held for sale.

Observation of the Physical Inventory Process. We selected a multistage stratified random sample of 662 items (forward physical inventory observations) for our evaluation of the physical inventory, categorization, and valuation processes; however, 30 items were not counted because the automated supply system cancelled the inventory prior to completion of the physical count and reconciliation. To ensure conservative statistical results, we treated the 30 items as if they were counted and no differences were noted. Forward physical inventories verify that on hand inventory balances agree with the inventory balance on the Fund's accountable record. Additionally, we judgmentally selected 329 items (reverse physical inventory observations) from the depot to verify that the inventory on hand was included on the Fund's accountable record.

Forward Physical Inventory Observations. We evaluated the physical inventory process at 15 storage depots operated by DLA, including the actual count process, the adjustment of the count quantity for in-float transactions, and the reconciliation of the adjusted count to the supply center's accountable record quantity. In-float transactions are receipts for materiel received at the storage depot that were not yet posted to the supply center records, and issues that were posted to supply center records but not yet shipped by the depot at the time of the physical inventory count. Physical inventory results, whether or not quantity adjustments existed, should be posted to the financial and distribution records to validate that the physical inventory count was completed, to record the results of the observed count balances, and to minimize recounting the same items.

The physical count and reconciliation process at storage depots for 632 items, valued at \$280.8 million, showed a net loss of \$3.3 million. Of the 632 items, 161 items showed losses of \$17.7 million, 182 items showed gains of \$14.4 million, and 289 items showed no quantity difference. However, the inventory results were not posted to the financial and distribution subsystems for 106 items because either depot personnel did not submit the results of physical inventory counts to the supply centers or supply center personnel did not validate and re-input rejected inventory transactions (see Appendix D).

Of the 632 physical inventory counts, 526 were posted to the accountable records (63 with differences other than observed), 17 were received by the supply center but were rejected from the supply system and not re-input, 60 were not received or processed, and 29 were canceled and not reported but were completed by depot personnel before the cancellation notice. For the 63 items that were posted with differences other than observed, the difference of the count and reconciliation was a net loss of \$2.7 million -- \$1.4 million in gains and \$4.1 million in losses. The difference posted to the supply records was a net loss of \$1.5 million -- \$2.0 million in gains and \$3.5 million in losses. We attributed the differences to incompatible computer systems, manual input errors, and errors made during the reconciliation process.

Supply center personnel did not research the 106 results of inventory transactions that were either rejected from the supply center files, not received or processed, or canceled because of incomplete disposal transactions. For the incomplete transactions, 25 items showed gains of \$5.3 million, 25 items showed losses of \$6.5 million, and the remaining 56 items showed no difference. We included the results of those physical inventories in our analyses and statistical projections of inventory tests.

Reverse Physical Inventory Observations. In addition to observing formal physical inventory counts, we selected a judgmental sample of 329 items from storage locations to determine whether the item was included on the accountable record of the supply centers. Of the 329 items, 4 were not on the accountable records. The discrepancies identified were not considered significant but were reported to DLA for correction.

Adequacy of Subsidiary Records

For other than stock on hand accounts, the general ledger account balances and other non-financial records did not reflect the correct value of the inventories. Subsidiary records and documentation for other than stock on hand accounts were inadequate. Subsidiary records included inventories with negative balances; inventories not supported by subsidiary records, and inventories intransit for more than 180 days (some in excess of 360 days). As a result, the reported inventory balances on the financial statement did not accurately represent the financial inventory value of inventory held for sale and inventory not held for sale. Appendix E shows the aging and value of general ledger accounts for other than inventory stock on hand and the differences between the value of the general ledger account balances and the subsidiary records.

The DLA supply management business area maintains six general ledger accounts for inventories other than stock on hand. Additionally, clothing factory inventories maintained in the operations and maintenance general ledger, include direct materiel, work-in-process, repair parts, and operating supplies. The general ledger account balances for those six inventory accounts, including clothing factory inventories, was \$375 million as of September 30, 1993. To evaluate the reasonableness of the recorded inventories other than stock on hand, we performed tests to determine whether the balances in the general ledger accounts used to support the Fund trial balance agreed with subsidiary records and related supporting documents and that the inventories were properly valued. We could not assess the completeness of those accounts because subsidiary records were either inaccurate, or were not available for review. We concluded that the financial information and documentary support for the six accounts was inaccurate.

Inventories With Contractors and Test Facilities. Inventories with contractors and test facilities (general ledger account code 131) represented the value of materiel issued to commercial contractors or Government activities. The inventories are used in the manufacture, modification, repair, or testing of components or end items that will be returned to stock fund inventory. The balance in the Fund's general ledger account was \$75.4 million. Our evaluation of \$60.7 million of the account balance showed \$108.1 million of positive inventory and \$47.5 million of negative inventory. Inventory is a tangible asset and should not have a negative value. The condition was previously reported in IG, DoD, Report No. 92-129, "Defense Stock Fund Financial Statements (Materiel Managed Under the Standard Automated Materiel Management System) for FY 1991," August 26, 1992. Additionally, the control account balances did not agree with the subsidiary records at the Defense Electronics Supply Center. DLA and Defense Finance and Accounting Service management indicated that no corrective action had been taken to validate the subsidiary records. Accordingly, we made no substantive tests of the account.

Inventories in the Process of Repair or Assembly/Disassembly. Inventory in the process of repair or assembly/disassembly (general ledger account code 132) represented the value of materiel in process of assembly, disassembly,

Presentation of Financial Data for Inventory Accounts and Other Non-Financial Resources

conversion, or repair by DLA storage or warehouse activities. The balance in the Fund's general ledger account was \$49.6 million. Our evaluation of \$38.6 million of the account balance showed \$43.5 million of positive inventory and \$5 million of negative inventory. Again, inventories are tangible assets and should not have negative values. The condition was also reported in IG, DoD, Report No. 92-129. Additionally, the control account balances did not agree with the subsidiary records at the Defense Electronics Supply Center. DLA and Defense Finance and Accounting Service management indicated that no corrective action had been taken to validate the subsidiary records. Accordingly, we made no substantive tests of the account.

Inventory Temporarily In Use. Inventory temporarily in use (general ledger account code 135) represented materiel that had been loaned or used for display purposes. The balance in the Fund's general ledger account was \$926,838. DLA Manual 7000.2, "Standard Automated Materiel Management System Financial System Operating Procedures," January 1992, states that a quarterly report will be prepared to support the account balance and the total of the report should be verified to ensure that it agrees with the general ledger account balance. DLA personnel were unable to provide us copies of the quarterly detailed subsidiary report. The condition was also reported in IG, DoD, Report No. 92-129. Accordingly, we made no substantive tests of the account.

Inventories Intransit From Procurement. Inventories intransit from procurement (general ledger account code 140) represented materiel that had been paid for but had not been reported as received as of the end of the accounting period, and materiel for which title had passed to the Government but had not been reported as received into inventory as of the end of the accounting period. We evaluated \$45.6 million of the total \$105.2 million in the general ledger account. Of the \$45.6 million, \$10.9 million (24 percent) of inventory was intransit for over 360 days and was of questionable validity.

We judgmentally selected a sample of inventory valued at \$7.6 million from the \$10.9 million intransit for over 360 days and determined that \$4.1 million (54 percent) was invalid, primarily because materiel was received under the wrong contract line items or was received, paid for, and subsequently returned to the contractor because the materiel was deficient. We were unable to make a determination for \$1.5 million (20 percent) of the inventory because information was not available. Contract files were either retired to storage or could not be located. The condition was also reported in IG, DoD, Report No. 92-129.

Inventories Intransit Between Storage Locations. Inventory intransit between storage locations (general ledger account code 141) represented the value of materiel that had been shipped and dropped from the inventory records of one storage location but had not been posted as a receipt at the receiving storage location. We evaluated \$55 million of the \$141.2 million in the account balance. The control account balances agreed only with the subsidiary records for the Directorate of Medical Materiel, Defense Personnel Support Center. Records for five supply centers were not in agreement. We did not review the fuel and subsistence commodities. No detailed subsidiary records were available for the subsistence commodity.

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DLA procedures state that if materiel cannot be located by the storage depot personnel within 90 days after the shipment date, a special inventory should be taken and if the materiel is not found, storage depot personnel should perform causative research for significant losses. The intransit should be cleared and an inventory loss taken. Of the \$55 million in the general ledger account, \$2.5 million (4 percent) was between 180 and 360 days intransit, and \$13.9 million (20 percent) was intransit over 360 days. We judgmentally selected a sample of 143 transactions valued at \$11.9 million, 142 from the \$16.4 million intransit for over 180 days, and 1 (valued at \$561,276) that was intransit between 120 and 180 days.

Approximately \$11 million (138 transactions) of the \$11.9 million intransits we tested were invalid because the materiel was never shipped; was received under an incorrect document number, or document identifier code; or the transactions were so old that a determination could not be made. When materiel was received under the wrong document number, or document identifier code, the due-in record was not properly adjusted. Therefore, an erroneous due-in record existed for a quantity of materiel that had already been received. Of the 143 transactions tested, 84 (59 percent) were from 2 to 9 years old. The inventory intransits were not written off and special inventories were not requested. The condition was also reported in IG, DoD, Report No. 92-129.

Inventories Intransit From Customer Sales Returns. Inventory intransit from customer sales returns (general ledger account code 142) represented the financial value of erroneous or defective materiel sold to customers but that were to be returned to the supply system for credit. The credit is applied to the customers' accounts before actual receipt of the materiel. The balance in the general ledger account was \$2.5 million, which did not agree with the total in the subsidiary records for all supply centers. We were unable to review intransit transactions at the Directorate of Medical Materiel, Defense Personnel Support Center, because the subsidiary report was not generated for the period ending September 30, 1993.

The Defense General Supply Center had no intransits over 180 days because installation personnel reviewed the subsidiary record and reversed all transactions over 180 days old. For the remaining four supply centers that had a subsidiary report, \$1.2 million (60 percent) of the \$2 million was intransit over 180 days and no action was taken to cancel the due-ins and reverse the credit provided to customers for the intransit materiel. DLA procedures provide that a subsidiary report supporting the balance in the general ledger account be provided for review. Prior to FY 1992, the subsidiary report included items intransit for over 165 days only. The subsidiary report now includes all intransit transactions.

We selected a judgmental sample of 60 transactions (valued at \$471,897) that were over 180 days old from the construction, electronics, and industrial commodities. Materiel for 2 of the 60 transactions was received shortly after the end of the fiscal year, 11 were received before the end of the fiscal year, and the remaining 47 were over a year old and had not been received. No action had been taken to cancel the due-ins and reverse the credit provided to the customer even though the due-ins were older than 180 days.

Inventory Valuations, Categorization, and Disclosures

Inventory values in general ledger accounts and non-financial records, and year-end accounting adjustments did not reflect the correct value of inventory under the control and management of DLA. Valuations, categorization, and disclosures on the financial statements were not done in accordance with Office of Management and Budget and DoD guidelines. As a result, the inventory balances presented on the financial statements were not properly categorized; were misstated; or did not disclose all restrictions on the sale, use, or disposition of inventories and other non-financial resources.

Inventory Valuations and Categorizations. Government accounting standards required that inventory be valued at historical cost or any valuation method which approximates historical cost, latest acquisition cost, market value, or the lower of cost or net realizable value. DoD guidance states that for financial statement purposes, inventory should be valued at the latest acquisition cost, the latest acquisition cost less the estimated cost of repair for unserviceable inventory, or 2.04 percent of the latest acquisition cost for potential reutilization or disposal inventory. The DoD guidance also states that assets will be categorized on the financial statements based on whether they are inventory held for sale, inventory not held for sale, or other non-financial resource and further subdivides them into discrete reportable asset categories.

We reviewed the categories of inventory stock on hand to determine whether the inventory value on the financial statements fairly represented the latest acquisition cost, or other appropriate valuation methods, and whether the assets were properly categorized for financial statement purposes. As discussed below, some categories of items were not valued using appropriate valuation methods.

Reutilization and Marketing Inventories. Reutilization and marketing inventories were overvalued on the financial statements and non-financial records by almost \$5 billion and Note 5 to the financial statements incorrectly states that the materiel was valued at original acquisition cost. Reutilization and marketing inventories are assets that were surplus to requirements of DoD Components and were turned in to the DRMS for disposal. The materiel was offered to other Federal agencies or, when no further need existed within the Federal Government, the materiel was offered for sale or donation to state and local governments and for sale to the general public. Surplus items with national stock numbers were valued at the standard price in effect at the time the materiel was turned in to the DRMS. Surplus items with local stock numbers were valued at whatever value the turn-in activity provided to the DRMS. Both valuation methods generally exceeded net realizable value.

Valuation of Inventory for Disposal. The "DoD Guidance on Form and Content of Financial Statements for FY 1993 and FY 1994 Financial Activity," states that "inventory in the process of disposal or stock not expected to survive repair will be valued at 2.04 percent of the original acquisition cost for the purpose of preparing these financial statements." Personnel at the Office of the Comptroller of the DoD told us that the 2.04 percent valuation was

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adopted for potential reutilization and disposal materiel held by wholesale supply centers and that no specific policy existed for valuing inventory held by DRMS. However, the 2.04 percent was based on the rate of return DRMS experienced on the sale of surplus inventory and represented the best estimate of net realizable value for surplus inventory held by DRMS.

DRMS did not report a value for reutilization and marketing inventory on the financial statements for FYs 1991 and 1992. The inventory was not under the financial control of a general ledger account; however, DRMS did maintain a non-financial report, "Report of Excess and Surplus Materiel at Disposal Activities," that showed the value of materiel on hand and the additions to and deletions from inventory. The report also showed the amount of proceeds received from the sale or disposition of the materiel. The report identified \$7.8 billion of inventory on hand as of September 30, 1993.

Use of FY 1992 Inventory Balance for FY 1993 Financial Statements. The FY 1993 financial statements reported a value of \$5.145 billion of materiel held for sale by the reutilization and marketing service business area. We discussed the differences with DRMS personnel and determined that the \$5.145 billion actually represented the ending balance for August 31, 1992, 13 months earlier. The non-financial report at DRMS showed that of the \$7.8 billion of inventory, \$5.2 billion was available for sale and \$2.6 billion was in varying screening categories. The materiel was valued at historical standard price and not net realizable value. During FY 1993, the average rate of return for materiel sold was 2.34 percent of the turn-in price (not the latest acquisition cost) for other than scrap sales, slightly higher than the 2.04 percent provided in the DoD guidance. Using those percentages for determining a net realizable value, DRMS inventory would be valued between \$158.8 million and \$182.1 million and categorized as inventory held for sale, nearly \$5 billion less than the amount presented on the financial statements.

Supply Center Potential Reutilization Inventory. Potential reutilization and disposal inventory held by DLA wholesale supply centers was understated by about \$30 million on the financial statements and Note 5 to the financial statements did not disclose that the materiel was categorized as inventory held for sale. Although Note 5 identified the valuation of the materiel used -- 2.04 percent of the latest acquisition cost of \$1.167 billion, in accordance with DoD guidance -- the percentage used did not accurately reflect the net realizable value.

Personnel in the then Office of the Assistant Secretary of Defense (Production and Logistics) advised us that the 2.04 percent represented the rate of return that the DRMS received from the sale or disposal of surplus inventory and other personal property. The 2.04 percent return was based on the standard price in effect at the time the materiel was turned in to the DRMS, not the latest acquisition cost. Standard price consists of the latest acquisition cost plus a surcharge that DLA includes to recover the supply management business area's cost of operation. The surcharge in FY 1993 for DLA commodities ranged from 15.8 percent to 41.1 percent. Consequently, potential reutilization materiel in the supply management business area was misstated because the rate of return was developed as a percentage of the standard price but was applied

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against the latest acquisition cost to determine the net realizable value. Because the latest acquisition cost is less than standard price, the net realizable value for potential reutilization materiel was understated.

Logistics Transfer Items. Items transferred to DLA, without subsequent buys, were overvalued on the general ledger account. Item management responsibility for items in the supply system changes over time. Defense Management Review Decision No. 926 requires the transfer of approximately 1 million consumable items from the Services to DLA under the consumable item transfer program. When those changes occur, materiel is transferred at the current standard price. The standard price includes the latest acquisition cost and a surcharge that covers the cost of operations and maintenance -- the cost of doing business. Logistics transfer items that were procured by the gaining supply manager before the end of the fiscal year were valued using the latest acquisition cost and were properly valued on the financial statements. However, items that were not procured by the gaining inventory manager by the end of the fiscal year were valued at the standard price of the losing supply manager -- a value greater than the latest acquisition cost.

We could not determine the number or dollar value of logistics transfer items that were valued in the general ledger at the losing inventory managers' standard price rather than at the latest acquisition cost. The improper valuation of logistics transfer items was reported in IG, DoD, Report No. 92-129, and corrective actions had not been taken.

Base Operating Supplies. Base operating supplies were incorrectly categorized and reported on the financial statements. DLA maintains a level of base operating supply inventories used to support the daily operation of supply centers and distribution depots. Base operating supplies, valued at \$18 million, \$7.5 million at supply centers and \$10.5 million at distribution depots, was included within inventory held for sale on the financial statements. The DoD guidance categorizes materiel and goods held for future agency consumption as inventory not held for sale. The supplies were incorrectly categorized as inventory held for sale and were attributed solely to the supply management business area instead of split between the supply management and distribution depots business areas in the amounts noted above.

Categorization and Disclosure. "DoD Guidance on Form and Content of Financial Statements for FY 1993 and FY 1994 Financial Activity," provides definitions for all asset accounts including inventory held for sale and inventory not held for sale. Note 5 to the financial statements should include the inventory valuation methods used; the value by selected subcategories of inventories; and any restrictions on the sale, use, or disposition of the asset.

We reviewed the financial statements data and Note 5 to the Fund's FY 1993 financial statements and determined that the value, value by subcategory of inventory, or restrictions to inventory in the Fund were incomplete, improperly categorized, or not fully disclosed. We used data obtained from the general ledger and other non-financial reports to determine the value of selected categories of inventory. Those misstatements are discussed below.

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Unserviceable Materiel. Note 5 to the financial statements for unserviceable materiel was incomplete. Although Note 5 properly identified the method of valuation for the unserviceable materiel -- 50 percent of the latest acquisition cost of \$178 million -- it did not disclose that the materiel was categorized as inventory held for sale.

War Reserve Materiel. Note 5 to the financial statements for war reserve materiel was incomplete and the materiel was improperly categorized. War reserve materiel was identified as restricted for sale, use, or disposition; however, the value of the materiel was not disclosed. Additionally, war reserve materiel was included in inventory held for sale. DoD guidance requires that war reserve materiel be included in inventory not held for sale and that the value of the inventory be disclosed in Note 5 to the financial statements. Based on wholesale supply records, \$1.5 billion of fuel inventory and \$269 million of subsistence inventory were held as war reserve materiel.

Cooperative Logistics Supply Support Arrangements Inventory. Note 5 to the financial statements did not disclose either the value of the assets or the restrictions on the sale, use, or disposition of cooperative logistics supply support arrangements inventory. Cooperative logistics supply support arrangements represented investments in inventory with funds received from the foreign military customers. The DLA investment in inventory was valued at \$106.8 million. DLA has title to the materiel until requisitioned by the foreign military customers; however, the materiel is restricted for sale to foreign military customers with cooperative logistics supply support arrangements. The value and the restriction on the sale, use, or disposition of the inventory should have been disclosed in Note 5 to the financial statements.

Litigation Inventories. Note 5 to the financial statements improperly categorized litigation inventories as inventories held for sale and did not fully disclose the restrictions on the inventory. The DoD guidance states that litigation inventories should be categorized as inventories not held for sale and they should be properly disclosed in Note 5 to the financial statements. Litigation inventories included materiel pending litigation or negotiation of disputes with contractors or common carriers. Ownership of the materiel is questionable until the litigation is completed. The general ledger accounts showed litigation inventories valued at \$59.6 million, \$25.4 million from new procurements and \$34.2 million from other than new procurements.

Reporting of Other Non-Financial Resources

Non-Financial Resources. Non-financial resources in general ledger accounts and non-financial records, and year-end accounting adjustments did not reflect the correct value of non-financial resources under the control and management of DLA. We reviewed the financial statements data and Note 10 to the Fund's FY 1993 financial statements and determined that the value and restrictions to non-financial resources in the Fund were incomplete and not fully disclosed.

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We used data obtained from the general ledger and other non-financial reports to determine the category and value of non-financial resources. Those misstatements are discussed below.

Industrial Plant Equipment. Other non-financial resources were reported as \$95.6 million on the financial statements. However, this did not include value of industrial plant equipment held by the industrial plant equipment business area of the Fund and Note 10 to the financial statements did not disclose the value, value by subcategory, or restrictions to the inventory. Additionally, the general ledger accounts did not reflect the value of industrial plant equipment under the management of the industrial plant equipment business area of the Fund. The equipment was either held in storage for possible use by DoD Components or was on loan to technical and vocational institutions. "DoD Guidance on Form and Content of Financial Statements for FY 1993 and FY 1994 Financial Activity," does not state how this type of industrial plant equipment will be valued on the financial statements and how it should be categorized. Personnel from the Office of the Comptroller of the DoD were unable to provide any guidance for valuing and categorizing this type of industrial plant equipment on the financial statements.

Because industrial plant equipment represents a tangible asset owned and managed by the Fund, we believe that it should be included as an asset on the financial statement of the Fund. Industrial plant equipment, under the control and management of DLA, does not result in an increase in financial resources and does not contribute to cash flow. Using the definitions for assets provided in the DoD guidance, DLA industrial plant equipment should be categorized as other non-financial resources, valued at an estimate of replacement cost (not subject to depreciation) and properly disclosed in Note 10 of the financial statements.

Industrial Plant Equipment in Storage. The Defense Industrial Plant Equipment Center, the only activity of the industrial plant equipment business area, was consolidated under the control and management of the Defense General Supply Center during FY 1993. Although the Defense General Supply Center is a division of the supply management business area, the financial reporting of the industrial plant equipment business area was still maintained as a separate reporting entity. DoD Components transfer unneeded industrial plant equipment to the industrial plant equipment business area for possible future use. If the equipment is needed, it is refurbished by the industrial plant equipment business area and shipped to the DoD Component. The DoD Component is charged only for the cost of refurbishing the equipment and transporting the equipment to the requisitioner. Reports provided by the Industrial Machinery Division, Defense General Supply Center, showed \$68 million, original acquisition cost, of industrial plant equipment at four DLA storage facilities as of September 30, 1993.

Industrial Plant Equipment on Loan. In addition to the industrial plant equipment stored at DoD storage facilities, the business area loaned \$34 million, original acquisition cost, of industrial plant equipment to technical and vocational institutions throughout the United States. No requirement

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existed or is anticipated for the equipment within DoD or other Federal organizations. DLA has requested congressional authority to transfer the unneeded equipment to technical and vocational institutions without offering the equipment to other Federal, state, and local Governments. Congressional authority had not been received as of September 30, 1993.

FY 1992 Comparative Financial Data

FY 1992 comparative financial data presented with the FY 1993 financial statements were not revised or footnoted to disclose deficiencies in the data that were reported in the FY 1992 audit of the Fund's financial statements (IG, DoD, Report No. 93-164, "Financial Statements of the Defense Logistics Agency Supply Management Division of the Defense Business Operations Fund [Defense Fuel Supply Center Financial Data] for FY 1992," September 2, 1993). On February 8, 1994, we discussed problems with the comparative data with DLA management. DLA advised us that no changes would be made to the FY 1993 financial statements unless the Comptroller of the DoD directed DLA to do so. The following conditions should be disclosed for comparative analysis.

- o DLA headquarters financial data of \$900 million and operations and maintenance financial data of \$1.8 billion were not supported by subsidiary records or developed from official accounting records. The financial data related to accounts receivable, undistributed collections, accounts payable, and undistributed disbursements.

- o Subsidiary records and supporting documentation were not available to support other adjustments of \$2.74 billion in the division's statement of cash flows.

- o The computation of the operations and maintenance adjustments affecting cash flows included in the division's statement of cash flows was not consistent with the commodity division's computation. The commodity division determined the adjustment by computing the change in account balances between the end of FY 1991 and FY 1992. The division's operations and maintenance adjustments were computed only on FY 1992 financial activity because the Defense Finance and Accounting Service considered the ending FY 1991 balance to be zero. The computation was not correct because the adjustments were computed on asset and liability accounts that would include an ending FY 1991 balance.

- o Defense Fuel Supply Center financial data for undistributed collections, claims receivable, accounts payable, unliquidated obligations, and undistributed disbursements were inaccurate. Additionally, prior period adjustments of \$159.7 million were recorded in FY 1992 financial data.

Recommendations, Management Comments, and Audit Response

Based on comments received from the Comptroller of the DoD, we modified Recommendations 2.a. and 2.c. to clarify the distinction between inventory held for sale, inventory not held for sale, and non-financial resources.

1. We recommend that the Director, Defense Logistics Agency:

a. Establish controls to ensure that physical inventory counts are accurately reported, that transactions are posted to the accountable records, that rejected transactions are re-input promptly, and that physical inventories are not canceled because of in-float disposal transactions.

b. Establish procedures and controls to correct the problems identified with inventory other than stock on hand accounts. The procedures should include:

o Periodic verification of subsidiary records with supporting documentation, including the research of imbalances between the control and subsidiary records;

o Review of unusual subsidiary records such as negative inventories and overage transactions; and

o Development of detailed subsidiary records for all inventory other than stock on hand accounts.

Defense Logistics Agency Comments. DLA concurred with Recommendation 1.a. but disagreed with the recommendation's implication that there are no legitimate reasons for canceling inventories, having differences between adjusted count quantities and reported count quantities, and not taking corrective actions in response to selected rejected count transactions. Additionally, DLA stated that it could provide specific examples of legitimate reasons.

DLA concurred with Recommendation 1.b. and stated that corrective actions would involve a review of existing policies, procedures, and interfaces between inventory control points and distribution depots. Corrective actions include the implementation of a standard distribution depot computer system and the release of a systems change that will improve the physical inventory process and transfer materiel accountability from the inventory control points to the distribution depots. Additional analysis of inventory other than stock on hand accounts would be made to determine the causes of negative inventory balances and what the delays are in clearing overage records. The estimated completion date is March 31, 1995. See Part IV of the report for the complete text of DLA's comments.

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Audit Response. Comments from DLA were responsive. However, the general comments to Recommendation 1.a. were not totally accurate. While there may be valid reasons to cancel physical inventories, inventories should not be canceled because of in-float disposal transactions. The disposal transaction should be treated the same as other in-float issues and receipt transactions.

Although differences may exist between the adjusted count quantities and posted count quantities, there should be no difference in the adjustment quantity (the gain or loss quantity) that is posted to the accountable records. However, differences still existed even though we considered all valid adjustments to the distribution depot and supply center count and reconciliation process. Additionally, not taking corrective action to rejected transactions negates the completed physical inventories and wastes the limited available resources. We request that DLA provide specific examples of legitimate reasons for the general comment made.

Comptroller of the DoD Comments. The Comptroller concurred in principle with the recommendation and stated that corrective actions will include a review of existing policies, procedures, and interfaces between supply activities and distribution depots. The actions will include the implementation of systems changes that will improve the physical inventory process and transfer accountability for materiel from supply centers to distribution depots. The Comptroller stated that a more comprehensive response will be provided to the final report. See Part IV of the report for the complete text of the Comptroller's comments.

Audit Response. Comments from the Comptroller were only partially responsive. Transferring physical accountability for inventories to distribution depots will not completely solve the existing problems of financial accountability. Inventory will still be accountable on the financial records of supply centers; and the supply centers will still rely on information provided by distribution depots. The Comptroller did not address Recommendation 1.b. that referred to correcting problems identified with inventory other than stock on hand. We request that the Comptroller provide additional comments to the recommendation.

2. We recommend that the Director, Defense Logistics Agency and the Director, Defense Finance and Accounting Service:

a. Establish procedures and controls to properly value and categorize all inventory as either inventory held for sale or inventory not held for sale and to properly value and categorize other non-financial resources.

Defense Logistics Agency Comments. DLA partially concurred with the recommendation. DLA stated that the Comptroller of the DoD sets inventory valuation policy and agreed that there was no specific valuation policy for Defense Reutilization and Marketing Service inventory and industrial plant equipment. Additionally, DLA stated that the valuation of inventory is being addressed by the Defense Business Operations Fund Corporate Board and that

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its request to revalue reutilization and marketing inventory at net realizable value was denied. Further, DLA stated that it intends to comply with the official inventory valuation and categorization policies in effect for the FY 1994 financial statements and implied that no changes would be made to the FY 1993 financial statements.

Audit Response. Comments from DLA were responsive to the recommendation. We appreciate the information provided in the response and request that copies of additional guidance from the Comptroller of the DoD or the Defense Business Operations Fund Corporate Board be provided to us for our information and use. We recognize that administrative and time constraints prevent the correction of the FY 1993 financial statements and related notes; however, we anticipate that the FY 1994 financial statements, including the comparative FY 1993 financial data, will be presented in accordance with appropriate guidance and this report.

Comptroller of the DoD Comments. The Comptroller partially concurred with the draft report recommendation and stated, "... the visibility of the categories of inventory has been expanded to follow the direction of the recommendation of the Federal Accounting Standards Advisory Board and the requirements of the Office of Management and Budget." Additionally, the Comptroller stated that other non-financial resources should not be considered inventory and that our definition of other non-financial resources was "incorrect and skews the entire audit."

The Comptroller further stated that we took liberties to define other non-financial resources so that we could include them in inventory accounts and develop findings and recommendations to support the definition. The Comptroller believes that DLA-owned industrial plant equipment meets the definition of property and should not be held to the reporting and footnoting requirements for inventory.

Audit Response. Comments from the Comptroller do not address the draft report recommendation to establish procedures and controls. The categories of inventory and related property defined in the DoD form and content guidance and the Office of Management and Budget Bulletin No. 93-02, "Form and Content of Agency Financial Statements," are not identical to the categories of inventory and related property defined in the Statement of Federal Financial Accounting Standards Number 3, "Accounting for Inventory and Related Property," October 27, 1993.

The definition of "other non-financial resources" on page 33 of this report is actually the same definition of "non-financial resources" provided in the DoD form and content guidance (page 3-17) and the Office of Management and Budget form and content guidance (page 13). Non-financial resources represent assets that are not intended to be sold or converted into financial resources for use in meeting the reporting entity's operational needs and that do not increase available financial resources for the reporting entity. Other non-financial resources is one of five categories of non-financial resources that also include resources transferable to the Treasury; non-Federal advances and prepayments;

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inventory not held for sale; and property, plant, and equipment. We believe that DLA-owned industrial plant equipment meets the definition of non-financial resources and should most accurately be reported on the financial statements as other non-financial resources.

We do not believe that including non-financial resources in the report "skews" the finding, discussions, or recommendations. The Comptroller stated that industrial plant equipment meets the definition of property but does not state whether that property was included on the financial statement in any asset category, what valuation method was used, and where the category of property was disclosed. We request that the Comptroller of the DoD provide additional comments to the unresolved issues.

Defense Finance and Accounting Service Comments. Comments were not received from the Defense Finance and Accounting Service. We request that the Defense Finance and Accounting Service provide comments to the final report.

b. Revise Note 5 of the financial statements to include the estimated overstatement of inventory held for sale based on statistical projections of physical inventory observations.

Defense Logistics Agency Comments. DLA partially concurred with the recommendation, agreeing that Note 5 should disclose any estimated overstatement or understatement. However, because of administrative and time constraints, DLA will not revise the FY 1993 notes to the financial statement. DLA stated that it will include the estimated overstatement and understatement in footnotes to the FY 1994 financial statements.

Audit Response. Comments from DLA were responsive. However, we believe that the estimated overstatement of inventory is material and should be disclosed in the notes to the financial statements and that failure to disclose the amount represents a material internal control weakness. We request that DLA provide additional comments to the recommendation in response to the final report.

Comptroller of the DoD Comments. The Comptroller nonconcurred with the recommendation and stated that the statistical projections do not provide adequate documentation to make prior period adjustments to accounting systems.

Audit Response. Comments from the Comptroller were not responsive to the recommendation. The recommendation does not require that data in accounting records be adjusted based on the statistical projections of physical inventory observations. We recommended that Note 5 to the financial statements disclose the estimated overstatement of the value of inventory held for sale reported on the financial statements. We request that the Comptroller provide additional comments to the recommendation in response to the final report.

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Defense Finance and Accounting Service Comments. Comments were not received from the Defense Finance and Accounting Service. We request that the Defense Finance and Accounting Service provide comments to the final report.

c. Disclose the restrictions on the sale, use, and disposition of inventory and other non-financial resources in accordance with the Office of Management and Budget and DoD guidance. Specifically, revise Notes 5 and 10 of the financial statements to identify the category of the inventory or other non-financial resources, the stated restriction, and the value of the restriction.

Defense Logistics Agency Comments. DLA partially concurred with the recommendation stating that because of administrative and time constraints, DLA will not revise the FY 1993 notes to the financial statement. DLA further stated that it will attempt to include the appropriate disclosures in the notes to the FY 1994 financial statements.

Audit Response. Comments from DLA were responsive. However, we believe that the disclosures on the restrictions to the sale, use, and disposition of inventory is material and should be disclosed in the notes to the financial statements and that failure to disclose the amounts represents a material internal control weakness.

Comptroller of the DoD Comments. The Comptroller nonconcurred with the recommendations and stated that the draft report improperly implied that DoD form and content guidance requires that inventories, for which restrictions apply, must be categorized as not held for sale. Additionally, the Comptroller took exception to our draft report recommendation to classify and disclose the amount of litigation inventories in the notes to the financial statements and stated that the Comptroller could, if requested or required to, provide guidance for the valuation and categorization of industrial plant equipment.

Audit Response. Comments from the Comptroller were not responsive to the draft report recommendation. The report states that selected asset categories, whether inventory held for sale, inventory not held for sale, or non-financial resources, should be properly categorized and valued, and that any restrictions on the sale, use or disposition of the asset should be disclosed in the notes to the financial statements.

The DoD guidance on form and content groups assets as financial and non-financial resources. Financial resources include inventories held for sale. Non-financial resources include inventories not held for sale and other non-financial resources. Financial and non-financial resources are defined below.

Financial Resources. Cash and other assets that can be readily converted into financial resources to meet current and future operational needs.

Presentation of Financial Data for Inventory Accounts and Other Non-Financial Resources

Non-Financial Resources. Those assets which, because of existing needs or legal limitations, are not intended to be sold or converted into financial resources for use in meeting the reporting entity's operational needs. Included are such assets as supplies inventories and property, plant and equipment. Also included are other assets which do not increase available financial resources for the reporting entity; for example, receivables the Federal Government is responsible for collecting on behalf of a third party.

The definition of inventory held for sale states, "The inventory valuation methods and any restrictions on use or convertibility shall be disclosed in Note 5." The definition for inventory not held for sale states, "...the inventory valuation methods, by category, as well as any restrictions on use or convertibility shall be disclosed in Note 5." We believe that war reserve materiel, cooperative logistics supply support arrangements inventory, and litigation inventory represent restrictions in the use or convertibility of inventories and require disclosure in Note 5 to the financial statements.

On February 2, 1994, we requested that our point of contact at the Office of the Comptroller provide written guidance on the valuation of potential reutilization and disposal materiel and the valuation, categorization, and disclosure of industrial plant equipment held by the industrial plant equipment business area of DLA. We received no written response. We were advised, by phone, that the Comptroller was still developing a policy on the valuation of potential reutilization and disposal materiel held by DRMS and that no policy had been established on industrial plant equipment held by DLA.

The Statement of Federal Financial Accounting Standards Number 3, "Accounting for Inventory and Related Property," defines inventory as follows.

"Inventory" is tangible personal property that is (1) held for sale, (2) in the process of production for sale, or (3) to be consumed in the production of goods for sale or in the provision of services for a fee. The term "held for sale" shall be interpreted to include items for sale or transfer to (1) entities outside the federal government, or (2) other federal entities. The principal objective of the sale or transfer of inventory is to provide a product or service for a fee that generally recovers full cost or an identified portion of the cost.

Industrial plant equipment represents a tangible asset owned and managed by the Fund, and we believe that it should be included as an asset on the financial statement of the Fund. The comments from the Comptroller do not state how industrial plant equipment held by DLA should be presented on the financial statements. We believe that our finding and recommendations are in accordance with the DoD guidance on the form and content of the financial statements. Lacking any definitive guidance, we appropriately categorized industrial plant equipment as other non-financial resources because it does not result in an increase in financial resources and it does not contribute to cash flow. We request that the Comptroller provide additional comments to the recommendation in response to the final report.

Presentation of Financial Data for Inventory Accounts and Other Non-Financial Resources

Defense Finance and Accounting Service Comments. Comments were not received from the Defense Finance and Accounting Service. We request that the Defense Finance and Accounting Service provide comments to the final report.

d. Revise the FY 1992 comparative financial data presented in the FY 1993 financial statements and disclose the deficiencies in the data as reported in the FY 1992 audit of the Fund's financial statement.

Defense Logistics Agency Comments. DLA nonconcurred with the recommendation stating that it does not support the idea of changing a certified financial statement after submission to the Office of Management and Budget. Because of administrative and time constraints, it was not in a position to revise the FY 1993 statements.

Audit Response. Comments from DLA were not responsive to the recommendation. During the mediation process of the FY 1992 audit, DLA stated that it would not implement the audit position that addressed adjustment or explanatory footnotes to the FY 1992 comparative data presented in the FY 1993 financial statements unless directed by the Comptroller of the DoD. We believe such adjustments or footnotes are necessary for comparative purposes. DLA has repeatedly stated that it cannot make changes to the FY 1993 financial statements because of administrative and time constraints. Because we issued our opinion on the FY 1992 financial statements and DLA is unwilling to make the requested changes to the comparative data on the FY 1993 financial statements, we will not pursue this issue.

Comptroller of the DoD Comments. The Comptroller nonconcurred with the recommendation and stated that no requirement exists for comparative footnotes to the principal statements. Additionally, procedural and systemic deficiencies in accounting systems were disclosed in the management representation letter.

Audit Response. Comments from the Comptroller were not responsive to the recommendation. The intent of the recommendation was not to require comparative footnotes in the financial statements. DLA elected not to revise the comparative FY 1992 financial data presented in the FY 1993 financial statements to correct the deficiencies reported in the FY 1992 audit of the Fund's financial statements. To ensure that the FY 1993 financial statements are informative of matters that may affect their use, understanding, and interpretation, we believe that DLA should fully disclose the deficiencies with the FY 1992 financial data in footnotes to the FY 1993 financial statements. The Comptroller's comment that known procedural and systemic problems were reported in DLA's management representation letter is not germane to the audited financial statements. Audit reporting standards require that the statements, including related notes, provide adequate disclosure of material matters. The management representation letter is not considered part of the financial statements. Because we issued our opinion on the FY 1992 financial statements and DLA is unwilling to make the requested changes to the comparative data on the FY 1993 financial statements, we will not pursue this issue.

Presentation of Financial Data for Inventory Accounts and Other Non-Financial Resources

Defense Finance and Accounting Service Comments. Comments were not received from the Defense Finance and Accounting Service. We request that the Defense Finance and Accounting Service provide comments to the final report.

3. We recommend that the Comptroller of the Department of Defense develop a method to value reutilization and disposal inventory held by wholesale supply activities that accurately reflects the best estimate of net realizable value.

Comptroller of the DoD Comments. The Comptroller nonconcurred with the recommendation and stated that the rate used to value potential reutilization and disposal materiel was applicable to all DoD Components and that the rate was developed by the Office of the Deputy Under Secretary of Defense for Logistics. Additionally, the Comptroller stated that DLA should request a waiver from the office issuing the rate in order to adjust the established rate and that the waiver should be included in the notes to the financial statements.

Audit Response. The Comptroller's response does not address the finding, related discussion, or the recommendation. The finding addressed two errors relating to the valuation of potential reutilization and disposal materiel used by DLA in the FY 1993 financial statements.

Reutilization and marketing inventories held by the DRMS were overvalued by \$5 billion because DLA did not revalue those inventories using the established rate provided by the Office of the Deputy Under Secretary of Defense for Logistics. The established rate was developed using information supplied by DRMS and actually represented the rate of return for materiel disposed of. The rate was computed dividing the total sales of disposed of materiel by the historical standard price of the materiel disposed of. That represented the best estimate of net realizable value for materiel held by the DRMS on September 30, 1993.

DLA wholesale supply centers value inventory at the latest acquisition cost, not the historical standard price. During FY 1993, the historical standard price for DLA commodities was 15.8 percent to 41.1 percent higher than the latest acquisition cost. Applying an established rate that was developed using historical standard price to the value of potential reutilization and disposal materiel valued at the latest acquisition cost, resulted in an estimated \$30 million understatement of inventory. We still believe that the rate used to value potential reutilization and disposal materiel held by wholesale supply activities needs to be reviewed to ensure that the rate represents a percentage that can be applied to the latest acquisition cost and not the historical standard price. We request that the Comptroller provide additional comments to the final report.

Part III - Additional Information

Appendix A. Inventory Accounts and Other Non-Financial Resources Presented on the DLA FY 1993 Financial Statements

The Defense Logistics Agency Defense Business Operations Fund presented financial data for assets that included inventory held for sale, inventory not held for sale, and other non-financial resources on the FY 1993 financial statements. The DoD form and content of financial statements categorizes assets on the financial statements as either financial or non-financial resources.

Financial Resources. Financial resources are defined as "cash and other assets that are intended to be readily converted into financial resources to meet current and future operational needs." Financial resources are further categorized as fund balances with the Treasury, cash, foreign currency, other monetary assets, non-Federal investments, non-Federal accounts receivable, inventories held for sale, non-Federal loans receivable, non-Federal advances and prepayments, property held for sale, other non-Federal financial resources, and intragovernmental items.

We limited our review of financial assets to inventories held for sale. The definition of inventories held for sale and the required disclosures are presented below.

Inventory held for sale. Tangible personal property held for sale in the ordinary course of business or which is in the process of production for such sale. Do not include stockpiled inventories or goods held for consumption. The inventory valuation methods and any restrictions on use or convertibility shall be disclosed in Note 5.

The value of inventory held for sale that was presented on the financial statements is shown below in Table A.1.

Table A.1. Inventory Held for Sale

<u>Business Area</u>	<u>Dollar Value</u>
Supply Management	\$11,198,238,446
Distribution Depots	0
Industrial Plant Equipment	0
Reutilization and Marketing	5,145,338,313
Clothing Factory	0
Total	<u>\$16,343,576,759</u>

Appendix A. Inventory Accounts and Other Non-Financial Resources Presented on the DLA FY 1993 Financial Statements

Non-Financial Resources. Non-financial resources are defined as "those assets which, because of existing needs or legal limitations, are not intended to be sold or converted into financial resources for use in meeting the reporting entity's operational needs. Included are such assets as supplies inventories and property, plant and equipment. Also included are other assets which do not increase available financial resources for the reporting entity; for example, receivables the Federal Government is responsible for collecting on behalf of a third party." Non-financial resources are further categorized as resources transferable to Treasury; inventories not held for sale; property, plant, and equipment; and other non-financial resources.

We limited our review of non-financial assets to inventories not held for sale and other non-financial resources. The definition of inventories not held for sale and the required disclosures are presented below.

Inventories not held for sale. Amounts of materiel and goods held for future agency consumption or stockpiled for use in national emergencies or for other purposes. Included are war reserve items. Any allowances for inventory losses, and the inventory valuation methods, by category, as well as any restrictions on use or convertibility shall be disclosed in Note 5.

The value of inventory not held for sale that was presented on the financial statements is shown below in Table A.2.

Table A.2. Inventory Not Held for Sale

<u>Business Area</u>	<u>Dollar Value</u>
Supply Management	\$118,166,323
Distribution Depots	0
Industrial Plant Equipment	0
Reutilization and Marketing	0
Clothing Factory	7,686,491
Total	<u>\$125,852,814</u>

Other Non-Financial Resources. Other non-financial resources are defined as "the total of all other non-financial resources, i.e., items that do not result in an increase in financial resources or cash. Include the value of property held that is not in use, seized property pending a declaration of forfeiture order, and pledged collateral acquired for which a disposition decision is pending. The components of other non-financial resources shall be disclosed in Note 10."

DLA financial statements for FY 1993 include \$95,557,539 for non-financial resources. The amount consisted of property, plant, and equipment that is no longer in use.

Appendix B. Audit Site Selection, Audit Sample Methodology, and Projections

Background

One objective of the audit was to determine whether the inventory accounts on the FY 1993 financial statement of the Fund are presented fairly in accordance with generally accepted accounting principles. Inventory are reported on the financial statements as either inventory held for sale or inventory not held for sale. Those categories consist of inventory that are identified in the general ledger accounts of the Fund as either inventory stock on hand or inventory other than stock on hand.

We used statistical sampling for inventory stock on hand to provide quantitative evidence to support an audit determination that the value of inventory reported on the financial statements was presented fairly in accordance with generally accepted accounting principles. Our tests were limited to inventory stock on hand, excluding fuel inventory, under the control and management of DLA that was stored at DLA distribution depots. We employed a multistage random sampling with stratification and sampling without replacement for the selection of audit sites and individual audit sample items.

The total universe included all DLA managed items in inventory stock on hand as of March 31, 1993, with a total dollar value of \$13.4 billion, valued at standard price. The inventory was located at 35 DLA storage depots. We subsequently eliminated 14 storage depots because the amount of inventory stock on hand accounted for less than 2 percent of the total DLA inventory. The total dollar value of inventory for the remaining 21 storage depots, our sample universe, was \$13.1 billion. The sample universe was used in selecting the audit site and audit sample, and the quantitative results of the sample items were projected to those 21 storage depots.

Audit Site Selection

We stratified the total dollar value of inventory stock on hand at 21 storage depots into three strata -- 6 storage depots with over \$1 billion of inventory, 10 storage depots with between \$200 million and \$1 billion of inventory, and 5 storage depots with less than \$200 million of inventory. For our physical inventory tests and observations, we selected all 6 storage depots in the first stratum, and randomly selected 7 of the 10 storage depots in the middle stratum, and 2 of the 5 storage depots in the low stratum.

Audit Sample Methodology

We stratified the total dollar value of inventory for the 15 storage depots by the dollar value for each sample item. A sample item was defined as a national stock number, in a condition code, stored at a depot. We selected a stratified random sample of 662 items at the 15 storage depots from a total of 3.8 million sample items available at the storage depots.

Projections

We are 90-percent confident that the net understatement of inventory, valued at the latest acquisition cost, for the 21 storage depots is from \$84 million to \$801 million. The unbiased point estimate, \$442 million, is the most likely single value for the net understatement at those sites. While the statistical sampling selection process was designed using the standard price of the sample items as of March 31, 1993, the difference measure was defined in terms of the latest acquisition cost at the time the physical inventory observations were made between September and October 1993. The statistical projection is valued at the latest acquisition cost during that period.

We measured the dollar value difference, valued at the latest acquisition cost, between the accountable record balance and the physical inventory observation quantity for each sample item. We valued unserviceable inventory at 50 percent of the latest acquisition cost in accordance with the DoD guidance on inventory valuation. To ensure conservative statistical results, we also valued differences for serviceable inventory at 50 percent of the latest acquisition cost when unserviceable materiel for the same item accounted for the identified loss or gain of the serviceable materiel.

Of the 662 sample items, 30 were not inventoried. The supply centers canceled the inventories because, in accordance with DLA procedures, outstanding disposal transactions had not been completed or because of supply management or administrative errors. To ensure conservative statistical results, we treated the 30 items as if they were counted and no differences were noted.

Appendix C. Summary of Prior Audits

During the last 3 years, three audit reports relating to the Chief Financial Officers Act reviews were conducted on various elements of the Fund. The reported conditions, recommendations, and management comments are summarized below.

- o IG, DoD, Report No. 94-035, "Financial Reporting for Defense Distribution Depots - Defense Logistics Agency Business Area of the Defense Business Operations Fund," February 8, 1994, stated that the distribution depot asset and liability accounts contained material inaccuracies, and that needed improvement, identified by prior audits, had not been implemented. No recommendations were made because of the outstanding corrective actions that were underway, but not implemented.

- o IG, DoD, Report No. 93-164, "Financial Statements of the Defense Logistics Agency Supply Management Division of the Defense Business Operations Fund (Defense Fuel Supply Center Financial Data) for FY 1992," September 2, 1993, stated that the inventory financial data were generally accurate; however, data in the financial statements were not properly supported; and information in the notes, overview, and supplemental financial and management information portions of the financial statements were incomplete and inaccurate. Recommendations were made to develop procedures to ensure that financial data are reconciled, supported, and accurate; that the financial statements are revised to include all required notes and supplemental information; and that the financial statements are reliable and accurate. Management nonconcurred with some of the noninventory findings and recommendations and stated that adjustments and disclosures identified would not be made to the FY 1992 comparative data presented in the FY 1993 financial statements and related notes.

- o IG, DoD, Report No. 92-129, "Defense Stock Fund Financial Statements (Materiel Managed Under the Standard Automated Materiel Management System) for FY 1991," August 26, 1992, identified the need for accounting adjustments to the original FY 1991 financial statements, including adjustments increasing the inventory financial data by \$18 million. Additionally, the financial statements did not contain footnote disclosures related to inventory restrictions and unsupported account balances; and problems were identified with the physical inventory process. The report recommended that adjustments be made to the original financial statements. Management generally concurred with the recommended changes to the original financial statements and actions taken or planned to improve internal control deficiencies and operational issues were considered generally responsive.

Appendix D. Summary of Physical Inventory Observations

We selected a multistage stratified random sample of 662 items for physical inventory observations at 15 storage depots. During DLA's counting process, 59 inventory counts were canceled because of outstanding disposal and receipt transactions. Before the automated cancellation, 29 items were counted and reconciled to the balance on the accountable records but the results of inventory were not reported to the supply centers. We included the results of the 29 items even though the results were not posted to the accountable records. Table D.1. shows the 632 items for which we were able to make a determination of the adjustment quantity. Table D.2. provides a summary of the 182 items with gains, Table D.3. is a summary of the 161 items with losses, and Table D.4. is a summary of the 289 items with no adjustment.

Table D.1. Total Items Reviewed

	<u>Sample Items</u>	<u>Net Adjustment Dollar Value</u>
Adjustment Processed	463	\$ 598,287.05
Processed With a Difference	63	(2,733,750.21)
Subtotal - Transactions Processed	526	(2,135,463.16)
Inventory Canceled	29	28,347.56
Not Received or Processed	60	(3,948,369.92)
Rejected and not Processed	17	2,708,418.99
Subtotal - Transactions not Processed	106	(1,211,603.37)
Total	632	(\$3,347,066.53)

Appendix D. Summary of Physical Inventory Observations

Table D.2. Items With Gains

	<u>Sample Items</u>	<u>Adjustment Dollar Value</u>
Adjustment Processed	<u>128</u>	<u>\$ 7,745,970.78</u>
Processed With a Difference	<u>29</u>	<u>1,382,937.05</u>
Subtotal - Transactions Processed	<u>157</u>	<u>9,128,907.83</u>
Inventory Canceled	5	885,036.34
Not Received or Processed	18	1,663,654.19
Rejected and not Processed	<u>2</u>	<u>2,716,674.77</u>
Subtotal - Transactions Not Processed	<u>25</u>	<u>5,265,365.30</u>
Total	<u>182</u>	<u>\$14,394,273.13</u>

Table D.3. Items With Losses

	<u>Sample Items</u>	<u>Adjustment Dollar Value</u>
Adjustment Processed	<u>104</u>	<u>(\$ 7,147,683.73)</u>
Processed With a Difference	<u>32</u>	<u>(4,116,687.26)</u>
Subtotal - Transaction Processed	<u>136</u>	<u>(11,264,370.99)</u>
Inventory Canceled	13	(856,688.78)
Not Received or Processed	9	(5,612,024.11)
Rejected and not Processed	<u>3</u>	<u>(8,255.78)</u>
Subtotal - Transactions Not Processed	<u>25</u>	<u>(6,476,968.67)</u>
Total	<u>161</u>	<u>(\$17,741,339.66)</u>

Table D.4. Items With No Adjustments

	<u>Sample Items</u>
Adjustment Processed	<u>231</u>
Processed With a Difference	<u>2</u>
Subtotal - Transactions Processed	<u>233</u>
Inventory Canceled	11
Not Received or Processed	33
Rejected and not Processed	<u>12</u>
Subtotal - Transactions Not Processed	<u>56</u>
Total	<u>289</u>

Appendix E. Analysis of Subsidiary Records for Other Than Stock on Hand Inventory Accounts

For other than stock on hand accounts, the general ledger account balances and other non-financial records did not reflect the correct value of the inventories. Subsidiary records included inventories with negative balances, and inventories intransit for more than 180 days (some in excess of 360 days). As a result, the reported inventory balances on the financial statement did not accurately represent the financial inventory value of inventory held for sale, inventory not held for sale, and other non-financial resources. The value of negative inventory balances and aging of the general ledger accounts for other than inventory stock on hand and the differences between the value of the general ledger account balances and the subsidiary records are presented in the following tables.

Table E.1. GLAC¹ 131 - Inventory With Contractors/Test Agencies

<u>Activity²</u>	<u>Account Balance</u>	<u>Negative Inventory</u>	<u>Positive Inventory</u>
DCSC	\$ 2,350,939.67	(\$ 19,157.49)	\$ 2,370,097.16
DESC	7,801,821.93 ³	(221,591.78)	8,019,143.44
DGSC	2,023,308.27	(57,495.66)	2,080,803.93
DISC	136,103.19	(352.45)	136,455.64
DPSC-M	17,000,654.32	(5,574,918.14)	22,575,572.46
DPSC-T	<u>31,344,051.58</u>	<u>(41,654,489.45)</u>	<u>72,998,541.03</u>
Subtotal	60,656,878.96	<u>(\$47,528,004.97)</u>	<u>\$108,180,613.66</u>
DPSC-S	14,283,798.41		
NSA	433,190.00		
Total	<u>\$75,373,867.37</u>		

¹General Ledger Account Code

²A list of the activities is at the end of the Appendix at *.

³The account balance does not add to the sum of the negative and positive inventory because the subsidiary record differs from the general ledger account by \$4,270.27. The Defense Fuel Supply Center (DFSC) showed no inventories with contractors and test agencies.

Appendix E. Analysis of Subsidiary Records for Other Than Stock on Hand Inventory Accounts

Table E.2. GLAC 132 - In the Process of Repair or Assembly/Disassembly

<u>Activity</u> ¹	<u>Account Balance</u>	<u>Negative Inventory</u>	<u>Positive Inventory</u>
DCSC	\$ 1,497,123.86	(\$ 245,390.77)	\$ 1,742,514.63
DESC	9,415.07 ²	0.00	18,982.36
DGSC	3,967,549.74	(83,840.10)	4,051,389.84
DISC	0.00	0.00	0.00
DPSC-M	24,623,079.78	(4,504,305.78)	29,127,385.56
DPSC-T	8,449,368.83	(128,835.68)	8,578,204.51
Subtotal	38,546,537.28	<u>(\$4,962,372.33)</u>	<u>\$43,518,476.90</u>
BOS	(2,276.28)		
DPSC-S	3,321,356.84		
Factory	7,686,491.00		
Total	<u>\$49,552,108.84</u>		

¹A list of the activities is at the end of the Appendix at *.

²The account balance does not add to the sum of the negative and positive inventory because the subsidiary record differs from the general ledger account by \$9,567.29. DFSC showed no inventories in the process of assembly/disassembly.

Table E.3. GLAC 135 - Temporarily in Use

<u>Activity</u>	<u>Account Balance</u> ²
DCSC	\$ 50,618.79
DESC	0.00
DGSC	842,651.40
DISC	3.01
DPSC-M	23,184.21
DPSC-T	10,380.30
Total	<u>\$926,837.71</u>

¹A list of the activities is at the end of the Appendix at *.

²There was no subsidiary record to support the balance in the general ledger accounts. DFSC and DPSC-S showed no inventories temporarily in use.

Appendix E. Analysis of Subsidiary Records for Other Than Stock on Hand Inventory Accounts

Table E.4. GLAC 140 - Intransit From Procurement

<u>Activity¹</u>	<u>Account Balance²</u>	<u>Intransit 181 to 360 Days</u>	<u>Intransit Over 360 Days</u>
DCSC	\$ 7,584,256.55	\$1,468,062.64	\$ 1,165,186.69
DESC	3,850,953.69	1,195,151.53	646,623.89
DGSC	7,547,751.74	1,432,417.90	1,441,421.05
DISC	9,256,404.87	1,026,597.64	2,537,171.88
DPSC-M	5,818,120.32	831,237.78	3,910,877.26
DPSC-T	<u>11,514,831.88</u>	<u>1,314,448.54</u>	<u>1,180,304.85</u>
Subtotal	45,572,319.05	<u>\$7,267,916.03</u>	<u>\$10,881,585.62</u>
BOS/NSA	1,433,034.11		
DFSC	38,179,993.90		
DPSC-S	<u>20,058,828.95</u>		
Total	<u>\$105,244,176.01</u>		

¹A list of the activities is at the end of the Appendix at *.

²The subsidiary record totals included transactions that had invalid dates that were not included in the aging report. DESC showed a difference of \$30,063.01 and DGSC showed a difference of \$2.04. The subsidiary record at DISC was \$25.00 larger than the general ledger trial balance as of September 30, 1993.

Table E.5. GLAC 141 - Intransit Between Storage Locations

<u>Activity¹</u>	<u>Account Balance²</u>	<u>Intransit 181 to 360 Days</u>	<u>Intransit Over 360 Days</u>
DCSC	\$ 6,697,108.93	\$ 173,957.92	\$ 113,559.68
DESC	5,069,962.30	229,913.14	896,534.01
DGSC	18,004,591.63	59,043.21	421,580.80
DISC	7,897,852.69	305,860.93	263,658.62
DPSC-M	3,714,607.57	776,081.51	1,983,009.94
DPSC-T	<u>14,486,894.27</u>	<u>925,632.96</u>	<u>10,246,801.05</u>
Subtotal	55,871,017.39	<u>\$2,470,489.67</u>	<u>\$13,925,144.10</u>
DFSC	58,733,704.48		
DPSC-S	<u>26,562,804.76</u>		
Total	<u>\$141,167,526.63</u>		

¹A list of the activities is at the end of the Appendix at *.

²The account balance differs from the subsidiary record by \$5,355.08 for DCSC, \$863,178.25 for DESC, (\$6.45) for DGSC, (\$15,281.72) for DISC, and \$8,654.36 for DPSC-T.

Appendix E. Analysis of Subsidiary Records for Other Than Stock on Hand Inventory Accounts

Table E.6. GLAC 142 - Intransit from Customer Sales Returns

<u>Activity</u> ¹	<u>Account Balance</u> ²	<u>Intransit 181 to 360 Days</u>	<u>Intransit Over 360 Days</u>
DCSC	\$ 846,163.53	\$191,974.71	\$203,623.79
DESC	435,208.90	169,398.90	105,977.66
DGSC	412,980.51	0.00	0.00
DISC	752,607.26	240,323.47	314,486.21
DPSC-T	12,446.41	0.00	12,109.00
Subtotal	2,459,406.61	<u>\$601,697.08</u>	<u>\$636,196.66</u>
DPSC-M ³	69,154.60		
Total	<u>\$2,528,561.21</u>		

¹A list of the activities is at the end of the Appendix at *.

²The account balance differs from the subsidiary record by \$5,530.53 for DCSC, (\$29,026.58) for DESC, (\$18,860.95) for DGSC, (\$10,887.12) for DISC, and \$337.41 for DPSC-T. There was no intransit inventories for DFSC and DPSC-S.

³No listing was available from DPSC-M for September 30, 1993.

*** Activity**

BOS	Base Operating Supplies
DCSC	Defense Construction Supply Center
DESC	Defense Electronics Supply Center
DFSC	Defense Fuel Supply Center
DGSC	Defense General Supply Center
DISC	Defense Industrial Supply Center
DPSC-M	Defense Personnel Support Center, Directorate of Medical Materiel
DPSC-S	Defense Personnel Support Center, Directorate of Subsistence
DPSC-T	Defense Personnel Support Center, Directorate of Clothing and Textiles
NSA	National Security Agency

Appendix F. Organizations Visited or Contacted

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology, Washington, DC
Comptroller of the Department of Defense, Washington, DC

Defense Agencies

Headquarters, Defense Logistics Agency, Alexandria, VA
Defense Construction Supply Center, Columbus, OH
Defense Electronics Supply Center, Dayton, OH
Defense General Supply Center, Richmond, VA
Defense Industrial Supply Center, Philadelphia, PA
Defense Personnel Supply Center, Philadelphia, PA
Defense Distribution Region East, New Cumberland, PA
 Defense Distribution Depot Albany, Albany, GA
 Defense Distribution Depot Charleston, Charleston, SC
 Defense Distribution Depot Cherry Point, Cherry Point, NC
 Defense Distribution Depot Columbus, Columbus, OH
 Defense Distribution Depot Memphis, Memphis, TN
 Defense Distribution Depot Red River, Texarkana, TX
 Defense Distribution Depot Richmond, Richmond, VA
 Defense Distribution Depot Susquehanna, Susquehanna, PA
 New Cumberland Facility, New Cumberland, PA
 Mechanicsburg Facility, Mechanicsburg, PA
 Defense Distribution Depot Warner Robins, Warner Robins, GA
Defense Distribution Region West, Stockton, CA
 Defense Distribution Depot Oakland, Oakland, CA
 Defense Distribution Depot Ogden, Ogden, UT
 Ogden Facility, Ogden, UT
 Defense Distribution Depot San Diego, San Diego, CA
 Defense Distribution Depot San Joaquin, CA
 Sharpe Facility, Stockton, CA
 Tracy Facility, Tracy, CA
Headquarters, Defense Finance and Accounting Service, Washington, DC
Defense Finance and Accounting Service, Columbus Center, Columbus, OH
 Dayton Center, Dayton, OH
 Richmond Center, Richmond, VA
 Philadelphia Center, Philadelphia, PA

Appendix G. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology
Assistant to the Secretary of Defense (Public Affairs)
Comptroller of the Department of Defense

Department of the Army

Secretary of the Army
Assistant Secretary of the Army (Financial Management)
Auditor General, Department of the Army

Department of the Navy

Secretary of the Navy
Assistant Secretary of the Navy (Financial Management)
Auditor General, Naval Audit Service

Department of the Air Force

Secretary of the Air Force
Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Air Force Audit Agency

Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
 Commander, Defense Construction Supply Center
 Commander, Defense Electronics Supply Center
 Commander, Defense General Supply Center
 Commander, Defense Industrial Supply Center
 Commander, Defense Personnel Support Center
 Commander, Defense Distribution Region East
 Commander, Defense Distribution Region West
 Commander, Defense Reutilization and Marketing Service
Director, Defense Finance and Accounting Service
 Director, Defense Finance and Accounting Service, Columbus Center
Director, National Security Agency
Inspector General, Central Imagery Office
Inspector General, Defense Intelligence Agency
Inspector General, National Security Agency
Director, Defense Logistics Studies Information Exchange

Non-Defense Federal Organizations

Office of Management and Budget

U.S. General Accounting Office

National Security and International Affairs Division, Technical Information Center

National Security and International Affairs Division, Defense and National

Aeronautics and Space Administration Management Issues

National Security and International Affairs Division, Military Operations and
Capabilities Issues

Chairman and Ranking Minority Member of each of the following Congressional
Committees and Subcommittees:

Senate Committee on Appropriations

Senate Subcommittee on Defense, Committee on Appropriations

Senate Committee on Armed Services

Senate Committee on Governmental Affairs

House Committee on Appropriations

House Subcommittee on Defense, Committee on Appropriations

House Committee on Armed Services

House Committee on Government Operations

House Subcommittee on Legislation and National Security, Committee on
Government Operations

Part IV - Management Comments

Comptroller of the DoD Comments

Final Report
Page No.



OFFICE OF THE COMPTROLLER OF THE DEPARTMENT OF DEFENSE

WASHINGTON, DC 20301-1100

MAY 31 1994

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING, DOD

SUBJECT: Inventory Accounts on the Financial Statements of the Defense Logistics Agency Business Areas of the Defense Business Operations Fund for FY 1993 (Project No. 3LD-2022)

Attached are departmental comments in reply to your memorandum of April 25, 1994, concerning a draft audit report on this subject.

Due to time limitations, the Department is responding only to the recommendations included in subject draft report. Comprehensive responses to both findings and recommendations will be provided upon issuance of the final report.

The Department is concerned that the auditors for this project included extraneous items in their categorization of "inventory" and attributed their definition to the Comptroller, DoD. The citation on page 4 that "Inventories, as defined in the 'DoD Guidance on Form and Content of Financial Statement for FY 1993 and FY 1994 Financial Activity,' include inventory held for sale, inventory not held for sale, and other nonfinancial resources," is incorrect and skews the entire audit.

"Other Non-Financial Resources" are not considered inventory and the definition on page 5 of the report attributed to DoD guidance does not exist. Consequently, the auditors have taken liberties to define those items included in inventory accounts and develop findings and recommendations to support their definition. In addition, items clearly included in the DoD and Office of Management and Budget definitions of property (lines 1.i. and 2.d. of the Statement of Financial Position) inappropriately have been included in the scope of this audit with findings and conclusions based on the reporting and footnoting requirements for inventories. Those items include Industrial Plant Equipment, Industrial Plant Equipment in Storage, and Industrial Plant Equipment on Loan.

My point of contact on these draft audit reports is Mr. Oscar Covell. He may be reached at (703) 697-6149.

Alvin Tucker
Deputy Chief Financial Officer

Attachment

INVENTORY ACCOUNTS ON THE FINANCIAL STATEMENTS OF THE
DEFENSE LOGISTICS AGENCY BUSINESS AREAS OF THE
DEFENSE BUSINESS OPERATIONS FUND FOR FY 1993
(PROJECT NO. 3LD-2022 DATED APRIL 25, 1994)

DEPARTMENT OF DEFENSE COMMENTS

* * * * *

RECOMMENDATIONS

- DODIG RECOMMENDATION 1.a.: We recommend that the Director, Defense Logistics Agency establish controls to ensure that physical inventory counts are accurately reported, that transactions are posted to the accountable records, that rejected transactions are re-input promptly, and that physical inventories are not canceled because of in-float disposal transactions.

DOD RESPONSE: Concur in principle. The Department will provide a more comprehensive response to the final report.

- DODIG RECOMMENDATION 1.b.: We recommend that the Director, Defense Logistics Agency establish procedures and controls to correct the problems identified with inventory other than stock on hand accounts. The procedures should include:
 - Periodic verification of subsidiary records with supporting documentation, including the research of imbalances between the control and subsidiary records;
 - Review of unusual subsidiary records such as negative inventories and overage transactions; and
 - Development of detailed subsidiary records for all inventory other than stock on hand accounts.

DOD RESPONSE: Concur. The corrective actions will involve a review of existing policies, procedures and interfaces between the inventory control points and distribution depots. Those actions will include the implementation of system changes which will improve the physical inventory process; and transferring accountability for material from supply centers to distribution depots.

- DODIG RECOMMENDATION 2.a.: We recommend that the Director, Defense Logistics Agency and the Director, Defense Finance and Accounting Service establish procedures and controls to properly value and categorize all inventories as either inventory held for sale, inventory not held for sale, or other nonfinancial resources.

DOD RESPONSE: Partially concur. The valuation policy for the presentation of inventory in financial statements remains as the Latest Acquisition Cost; however, the visibility of the categories of inventory has been expanded to follow the direction of the recommendation of the Federal Accounting Standards Advisory Board (FASAB) and the requirements of the Office of Management and Budget (OMB). Inventory held for sale and inventory not held for sale will be displayed in the footnotes to the principal statements in response to the revised procedures. "Other Non-financial Resources" is not considered inventory and is composed of items such as property held but not in use, seized property and pledged collateral, as specified in OMB Bulletin 93-02. Inventory value and categorization are the responsibility of the Defense Logistics Agency (DLA). The Defense Finance and Accounting Service (DFAS) is responsible for maintaining the accuracy of inventory values properly recorded in the accounting systems.

- **DODIG RECOMMENDATION 2.b.:** We recommend that the Director, Defense Logistics Agency and the Director, Defense Finance and Accounting Service revise Note 5 of the financial statements to include the estimated overstatement of inventory held for sale based on statistical projections of physical inventory observations.

DOD RESPONSE: Nonconcur. Such statistical projections do not provide adequate documentation for making prior period adjustments at the departmental level, or for ensuring that prior period adjustments transactions are identified to responsible installations for input into feeder accounting systems.

- **DODIG RECOMMENDATION 2.c.:** We recommend that the Director, Defense Logistics Agency and the Director, Defense Finance and Accounting Service disclose the restrictions on the sale, use, and disposition of inventories in accordance with the Office of Management and Budget and DoD guidance. Specifically, revise Notes 5 and 10 of the financial statements to identify the category of the inventory, the stated restriction, and the value of the inventory with a restriction for all categories of inventories.

DOD RESPONSE: Nonconcur. The audit report improperly implies that DoD form and content guidance requires that inventories, for which restrictions apply, must be categorized as not for sale. Such is not the case. Inventory program managers are responsible for classifying inventories as for sale or not for sale. The statement "The DoD guidance states that litigation inventories should be categorized as inventories not held for sale and they should be properly disclosed in Note 5 to the financial statements" is incorrect; the DoD guidance on form and content of financial

statements does not address litigation inventories nor their classification or disclosure in financial statements. In addition, the statement that "Personnel from the Office of the Comptroller of the DoD were unable to provide any guidance for valuing and categorizing this type of industrial plant equipment on the financial statements" is erroneous. Cognizant personnel in the office of the DoD Comptroller could provide guidance if requested or required.

- DODIG RECOMMENDATION 2.d.: We recommend that the Director, Defense Logistics Agency and the Director, Defense Finance and Accounting Service revise the FY 1992 comparative financial data presented in the FY 1993 financial statements and disclose the deficiencies in the data as reported in the FY 1992 audit of the fund's financial statement.

DOD RESPONSE: Nonconcur. There is no requirement at this time for comparative footnotes to the principal statements. The known procedural and systemic deficiencies in accounting systems were properly disclosed by the DLA as an attachment to the management representation letter forwarded to the DoD Assistant Inspector General for Auditing on April 21, 1994.

- DODIG RECOMMENDATION 3. We recommend that the Comptroller of the Department of Defense develop a method to value reutilization and disposal inventory held by wholesale supply activities that accurately reflects the best estimate of net realizable value.

DOD RESPONSE: Nonconcur. The rate developed by the Office of the Deputy Under Secretary of Defense (Logistics), for potential reutilization or disposable property is applicable to all DoD Components. Should a single component, as in the case of DLA, have need to adjust the rate due to its materiality, the office issuing the rate should be contacted and asked for a waiver. Any subsequent waiver should be footnoted in the financial statements.

Defense Logistics Agency Comments



DEFENSE LOGISTICS AGENCY
HEADQUARTERS
CAMERON STATION
ALEXANDRIA, VIRGINIA 22304-6100



IN REPLY
REFER TO

DDAI

08 JUN 1994

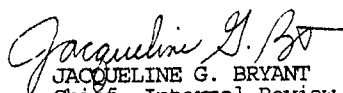
MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING,
DEPARTMENT OF DEFENSE

SUBJECT: OIG Audit Report on "Inventory Accounts on the
Financial Statements of the Defense Logistics
Agency Business Areas of the Defense Business
Operations Fund for FY 1993"
(Project No. 3LD-2022)

1. This is in response to your 25 April 1994 request.
2. **Recommendations 1.b and 2.a** have ongoing actions. Their estimated completion date is 31 March 1995. All other recommendations are either considered complete or are contingent upon the publication of the FY 1994 financial statements.

1 Encl

cc:
FO


JACQUELINE G. BRYANT
Chief, Internal Review Office

FORMAT 1 OF 6

TYPE OF REPORT: AUDIT

DATE OF POSITION:

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE: Inventory Accounts on the Financial Statements of the
Defense Logistics Agency Business Areas of the Defense
Business Operations Fund for FY 1993 (Project No. 3LD-2022)

RECOMMENDATION 1.a. We recommend that the Director, Defense Logistics Agency establish controls to ensure that physical inventory counts are accurately reported, that transactions are posted to the accountable records, that rejected transactions are re-input promptly, and that physical inventories are not canceled because of in-float disposal transactions.

DLA COMMENTS: Concur. However, we would like to make one general comment. The recommendation implies that there are not any legitimate reasons for 1) cancelling inventories, 2) having differences between adjusted count quantities and reported count quantities and 3) not taking corrective actions in response to selected rejected count transactions. There are legitimate reasons for the above. We can provide you with specific examples.

INTERNAL MANAGEMENT CONTROL WEAKNESS:

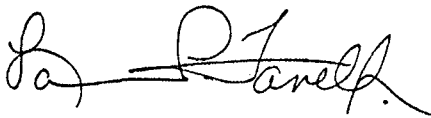
- () Nonconcur.
- (x) Concur; however, weakness is not considered material.
- () Concur; weakness is material and will be reported in the DLA Annual Statement of Assurance.

ACTION OFFICER: Carolyn Farley, MMDOI, x77245, 25 May 1994
PSE REVIEW/APPROVAL: James S. Rountree, CAPT, Acting Chief Financial
Officer, 26 May 1994
COORDINATION: James O'Laughlin, FOX, x46100, 25 May 1994
L. Coulter, DDAI, 31 May 1994

8 Ramon J. Bryant, DDFI, 1 Jun 94

DLA APPROVAL:

6 JUN 1994



LAWRENCE F. FARRELL, JR.
Major General, USAF
Principal Deputy Director

Defense Logistics Agency Comments

FORMAT 2 OF 6

TYPE OF REPORT: AUDIT

DATE OF POSITION:

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE Inventory Accounts on the Financial Statements of the Defense Logistics Agency Business Areas of the Defense Business Operations Fund for FY 1993 (Project No. 3LD-2022)

RECOMMENDATION 1.b. We recommend that the Director, Defense Logistics Agency establish procedures and controls to correct the problems identified with inventory other than stock on hand accounts. The procedures should include:

- o Periodic verification of subsidiary records with supporting documentation, including the research of imbalances between the control and subsidiary records;
- o Review of unusual subsidiary records such as negative inventories and overage transactions
- o Development of detailed subsidiary records for all inventory other than stock on hand accounts.

DLA COMMENTS: Concur. The corrective actions involve a review of existing policies, procedures and interfaces between the inventory control points and distribution depots. As you know, there also were some problems caused by the transfer of the service depots to DLA. Corrective actions include the implementation of DSS at all the DWASP/DDS sites, release of systems change, USDOH 1-16R3, that will improve the physical inventory process and the deployment of DSS increment 5A that will transfer materiel accountability from the ICP to the depot.

We need to do further analysis of the problems that are creating imbalances between the control and subsidiary records, determining the causes of the negative inventory balances, finding out what the delays are in clearing overage records and determining what can be done to assure that source documentation is available to support the subsidiary records. We suspect that there are resource issues, system and procedural issues.

INTERNAL MANAGEMENT CONTROL WEAKNESS:

- () Nonconcur.
- (x) Concur; however, weakness is not considered material.
- () Concur; weakness is material and will be reported in the DLA Annual Statement of Assurance.

ACTION OFFICER: Carolyn Farley, MMDOI, x 77245, 25 May 1994

PSE REVIEW/APPROVAL: James S. Rountree, CAPT, Acting Chief Financial Officer, 26 May 1994

COORDINATION: James O'Laughlin, FOX, x46100, 25 May 1994
L. Cpulter, DDAI, 31 May 1994

DLA APPROVAL:

[Handwritten signature]
James S. Rountree

FORMAT 3 OF 6

TYPE OF REPORT: AUDIT

DATE OF POSITION:

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE: Inventory Accounts on the Financial Statements of the
Defense Logistics Agency Business Areas of the Defense
Business Operations Fund for FY 1993 (Project No. 3LD-2022)

RECOMMENDATION 2.a. We recommend that the Director, Defense Logistics Agency and the Director, Defense Finance and Accounting Service establish procedures and controls to properly value and categorize all inventories as either inventory held for sale, inventory not held for sale, or other non-financial resources.

DLA COMMENTS: Partially concur. As you know the DoD guidance for the FY 1993 financial statements provides general definitions and general categorization criteria for inventory accounts. DLA's general ledger inventory accounts are more detailed than the DoD accounts. We appreciate your clarification of how we should categorize inventory in the financial statements and footnotes.

OMB Bulletin No. 94-01 provides revised guidance for the FY 1994 financial statements. OMB bulletin 94-01 classifies "inventories" on the statement of financial position as:

- o Inventory, Net
- o Operating Materials and Supplies, Net
- o Stockpile Materials, Net
- o Other Entity Assets

Note No. 8 of the OMB guidance shows that the "Inventory, Net" line will include:

- o Inventory held for current sale
- o Inventory held in reserve for future sale
- o Excess, obsolete, and unservicable

As shown above, the break out that you are suggesting for inventory held for sale and inventory not held for sale will only appear in the footnotes. Additionally, our initial feeling is that IPE inventory will be classified as "Other Entity Assets." We expect that OSD will issue revised guidance that reflects the changes set forth by OMB. We intend to comply with the "categorization" policy in effect for the FY 1994 financial statements.

For the valuation issues in your recommendation, we have the following comments:

o Inventory valuation policy is set forth by the DoD Comptroller. DLA and DFAS cannot bypass OSD and develop procedures and controls to value inventory when specific valuation policy has not been agreed to by OSD.

Defense Logistics Agency Comments

o We agree with your assessment that there is no specific valuation policy for Defense Reutilization and Marketing Service (DRMS) inventory and Industrial Plant Equipment (IPE).

o We need to evaluate whether we will be able to accurately estimate the replacement cost of IPE before we recommend this valuation to OSD.

o DoD's inventory valuation policy is currently being addressed by the DBOF Corporate Board Special Committee for Oversight of Policy Actions. We assume that you know (since the DoD IG participates on the committee) that we have formally proposed that DoD's inventory valuation policy also pertains to DRMS inventory and requires valuation at NRV. In August 1993, both HQ DLA and DFAS Columbus agreed that DRMS inventory should be reported at lower of cost or market. We informally attempted to get the authority to report DRMS inventories at Net Realizable Value (NRV), but we were denied. The denial was based on an interpretation of Chapters 31 and 37 of DoD 7220.9-M which requires that property turned in to DRMS be at acquisition/historical cost.

In summary, we intend to comply with official inventory valuation and categorization policies in effect for the FY 1994 financial statements.

INTERNAL MANAGEMENT CONTROL WEAKNESS:

- (x) Nonconcur.
- () Concur; however, weakness is not considered material.
- () Concur; weakness is material and will be reported in the DLA Annual Statement of Assurance.

ACTION OFFICER: Richard Sninsky, FOX, x46481, 25 May 1994
PSE REVIEW/APPROVAL: James S. Rountree, CAPT, Acting Chief Financial Officer, 26 May 1994
COORDINATION: James O'Laughlin, FOX, x46100, 25 May 1994
L. Coulter, DDAI, 31 May 1994
S. Fane for J. Rountree, DDAI, 1 Jun 94

DLA APPROVAL:



LAWRENCE J. FARNELL, JR.
Major General USAF
Principal Deputy Director

FORMAT 4 OF 6

TYPE OF REPORT: AUDIT

DATE OF POSITION:

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE: Inventory Accounts on the Financial Statements of the Defense Logistics Agency Business Areas of the Defense Business Operations Fund for FY 1993 (Project No. 3LD-2022)

RECOMMENDATION 2.b. We recommend that the Director, Defense Logistics Agency and the Director, Defense Finance and Accounting Service revise Note 5 of the financial statements to include the estimated overstatement of inventory held for sale based on statistical projection of physical inventory observations.

DLA COMMENTS: Partially concur. We agree that Note 5 should disclose any estimated overstatement or understatement. However, for practical, cost/benefit, and administrative reasons we will not revise Note 5. Unfortunately, the timing of the CFO due dates do not make adjustments to the financial statements and/or footnotes feasible at this juncture. When the FY 1994 financial statements are prepared, we intend to disclose in the footnotes the estimated DRMS inventory overstatement and the estimated Supply Management understatement pertaining to the FY 1993 inventory values.

INTERNAL MANAGEMENT CONTROL WEAKNESS:

- (x) Nonconcur.
- () Concur; however, weakness is not considered material.
- () Concur; weakness is material and will be reported in the DLA Annual Statement of Assurance.

ACTION OFFICER: Richard Sninsky, FOX, x46481, 25 May 1994
PSE REVIEW/APPROVAL: James S. Rountree, CAPT, Acting Chief Financial Officer, 26 May 1994
COORDINATION: James O'Laughlin, FOX, x46100, 25 May 1994
L. Cpulter, DDAI, 31 May 1994
J. Ramey for J. Bryant, D DAI, 1 June 94

DLA APPROVAL:



J. RAMEY
J. RAMEY, JR.
J. RAMEY, JR.
J. RAMEY, JR.

Defense Logistics Agency Comments

FORMAT 5 OF 6

TYPE OF REPORT: AUDIT

DATE OF POSITION:

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE: Inventory Accounts on the Financial Statements of the
Defense Logistics Agency Business Areas of the Defense
Business Operations Fund for FY 1993 (Project No. 3LD-2022)

RECOMMENDATION 2.c. We recommend that the Director, Defense Logistics Agency and the Director, Defense Finance and Accounting Service disclose the restrictions on the sale, use, and disposition of inventories in accordance with the Office of Management and Budget and DoD guidance. Specifically, revise Notes 5 and 10 of the financial statements to identify the category of the inventory, and the stated restriction, and the value of the inventory with a restriction for all categories of inventories.

DLA COMMENTS: Partially concur. As we stated in response to Recommendation No. 2.a. and 2.b., revisions to the FY 1993 footnotes are not feasible at this time. We will attempt to disclose the recommended categorizations, restrictions, and values pertaining to the FY 1993 inventories in the FY 1994 footnotes.

INTERNAL MANAGEMENT CONTROL WEAKNESS:


- (x) Nonconcur.
- () Concur; however, weakness is not considered material.
- () Concur; weakness is material and will be reported in the DLA Annual Statement of Assurance.

ACTION OFFICER: Richard Sninsky, FOX, x46481, 25 May 1994
PSE REVIEW/APPROVAL: James S. Rountree, CAPT, Acting Chief Financial Officer, 26 May 1994

COORDINATION: James O'Laughlin, FOX, x46100, 25 May 1994
L. COULTER, DDAI, 31 MAY 1994

S. Ramsey, DDAI, 1 June 94

DLA APPROVAL:


LAWRENCE F. FARRELL, JR.
Major General, USAF
Principal Deputy Director

FORMAT 6 OF 6

TYPE OF REPORT: AUDIT

DATE OF POSITION:

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE: Inventory Accounts on the Financial Statements of the Defense Logistics Agency Business Areas of the Defense Business Operations Fund for FY 1993 (Project No. 3LD-2022)

RECOMMENDATION 2.d. We recommend that the Director, Defense Logistics Agency and the Director, Defense Finance and Accounting Service revise the FY 1992 comparative financial data presented in the FY 1993 financial statements and disclose the deficiencies in the data as reported in the FY 1992 audit of the Fund's financial statement.

DLA COMMENTS: Nonconcur. We do not support the idea of changing a certified financial statement after submission to the Office of Management and Budget (OMB). Additionally, as discussed in our response to Recommendation No. 2.a. through 2.c., we are not in a position to revise the FY 1993 footnotes. Our specific comments to the finding bullets are as follows:

- o We believe that Note 2 of the FY 1993 financial statements adequately discloses the FY 1992 and FY 1993 dollar differences between the "operations" collections and disbursements per the general ledger and the Appropriation Control and Reporting System (ACRS) cash book. Additionally, Note 26 discloses the material overstatement of the accounts receivable and the cause of the problem. As you know, \$885 million of the \$900 million of the "headquarters financial data" is related to undistributed amounts. In summary, we disclosed the dollar amounts of the "unsupported" financial data, the cause of the problem (unreconciled disbursements and collections), and the needed corrective action.

- o While we believe in the full disclosure principle, we do not believe it is necessary to disclose a past misinterpretation of Defense Business Operations Fund (DBOF) policy that has no effect on the bottom-line/ending cash position. If policy was interpreted correctly the cash flow statement would have reported the "other adjustments" amount on other lines of the statement. Since there is no impact on the ending cash position, we do not believe that this is a financial fact significant enough to influence the judgement of an informed reader.

- o The computation of the FY 1992 "operations" portion of the Cash Flow Statement was indeed correct. DBOF guidance was that the DBOF account was not a successor account for the former "Operations and Maintenance" (O&M) appropriations. The guidance specifically stated that the O&M assets and liabilities shall not be transferred to the DBOF. The computations correctly used beginning balances of \$0 as the O&M assets and liabilities did not transfer to DBOF and were maintained as separate accounting entities. We apologize for not bringing this to your attention during the FY 1992 audit.

- o The fourth bullet is basically the same issue as the first bullet. In addition to our comments above, we do not believe it is

practical or necessary to separately disclose financial facts (undistributed amounts, etc.) below the business area level. Currently our Supply Management business area consists of approximately thirty general ledgers. If sub-allotments were considered, the number of entities would increase. We view the business of Supply Management in total and believe that the most useful disclosures are also at the business area level. Again, we believe in full disclosure, but not in information overload.

Finally, it is not reasonable to expect one supply center in one DBOF business area in the DoD to implement a change to the accounting and financial reporting procedures for prior period adjustments before policy is developed and system changes are made. As you know, OMB just recently changed the U.S. Standard General Ledger and the formats for the FY 1994 financial statements to accurately account for and report prior period adjustments according to GAAP. Recognition and accounting for these transactions is complicated and we believe that manual processing and summarization will lead to further inaccurate financial reporting. Manual recognition and disclosure of "true" prior period adjustments recorded in current year operating results would require an analysis of all manual journal vouchers by knowledgeable accountants. We believe that the cost of manually performing this function would outweigh the financial reporting benefits. We intend to account for and report "true" prior period adjustments when policy authorizes us to use this account, and systems are changed.

INTERNAL MANAGEMENT CONTROL WEAKNESS:

- (x) Nonconcur.
- () Concur; however, weakness is not considered material.
- () Concur; weakness is material and will be reported in the DLA Annual Statement of Assurance.

ACTION OFFICER: Richard Sninsky, FOX, x46481, 25 May 1994
PSE REVIEW/APPROVAL: James S. Rountree, CAPT, Acting Chief Financial Officer, 26 May 1994
COORDINATION: James O'Laughlin, FOX, x46100, 25 May 1994
L. Coulter, DDAI, 31 May 1994
A. Rouse, DDAI, 1 Jun 94

DLA APPROVAL:



JAMES S. ROUNTREE, JR.
CAPT, USAF
Acting Chief Financial Officer